

U.S. TRADE WITH CHINA

HEARING
BEFORE THE
SUBCOMMITTEE ON TRADE
OF THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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U.S. TRADE WITH CHINA

THURSDAY, FEBRUARY 15, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON TRADE,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:30 a.m., in room 1100, Longworth House Office Building, Hon. Sander M. Levin (Chairman of the Subcommittee), presiding.
[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TRADE

FOR IMMEDIATE RELEASE
February 06, 2007
TR-1

CONTACT: (202) 226-0158

Trade Subcommittee Chairman Levin Announces a Hearing on Trade with China

Ways and Means Trade Subcommittee Chairman Sander M. Levin today announced the Trade Subcommittee will hold the first in a series of hearings on the U.S.-China trade relationship. **The hearing will take place on Thursday, February 15, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be heard from both invited and public witnesses. Witnesses are expected to include a representative from the Office of the U.S. Trade Representative. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee or for inclusion in the printed record of the hearing.

FOCUS OF THE HEARING:

This hearing is the first in a series on U.S.-China economic and trade relations. The hearings will focus on the impact of U.S.-China trade on jobs, wages, prices, manufacturing competitiveness, and other aspects of the U.S. economy; the causes of the U.S. trade deficit with China; China's compliance with its WTO commitments; and China's role in the world economy. This hearing will be divided into two panels. The first panel will focus on the role and effect of subsidies in the Chinese market and their impact on competition with U.S. products in China. The other panel will focus on China's enforcement of intellectual property rights.

BACKGROUND:

Trade flows between the United States and China are substantial and growing. U.S. exports to China in the first 11 months of 2006 were more than \$50 billion, up from \$42 billion in all of 2005, and up from just \$19 billion in 2001, the year China acceded to the World Trade Organization. Notwithstanding this substantial growth in U.S. exports, the U.S. goods trade deficit with China in 2006 is expected to approach one-quarter of a trillion dollars—the largest trade deficit in U.S. history. China accounts for roughly 12 percent of total U.S. trade and one-third of the total U.S. goods trade deficit with the world. At the same time, U.S. imports from other East Asian countries have fallen \$10 billion between 2001 and 2005. The United States had a services trade surplus with China of \$2.6 billion in 2005.

It is widely recognized that China has a large number of subsidy programs that distort the Chinese market and trade with the United States. In 2006, China submitted a long-overdue subsidies notification to the World Trade Organization. China identified over 70 subsidy programs (including some subsidies that appear to be prohibited under WTO rules), but even that notification was incomplete.

China has a dismal record of enforcing intellectual property rights. For example, China's market access restrictions and resulting pirate market growth have been estimated to cost the U.S. copyright industries about \$2.4 billion in 2005. The piracy rates of physical copyright products remain virtually the highest in the world, at 85–95 percent depending on the industry sector and product format (e.g., 95 percent of DVDs in China are pirate).

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Cooper Smith at (202) 225-1721 no later than the close of business **Friday, February 9, 2007**. The telephone request should be followed by a formal written request faxed to Janice Mays, Chief of Staff, the Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515, at (202) 226-0158. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225-1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing in lieu of a personal appearance. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED.** The full written statement of each witness will be included in the printed record, in accordance with House Rules.

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 200 copies and email their prepared statement for review by Members prior to the hearing. Please attach your statement as a Word or WordPerfect document and email to hearingclerks.waysandmeans_d@mail.house.gov. **Testimony should arrive at the Subcommittee office, 1104 Longworth House Office Building, no later than close of business on Monday, February 12, 2007.** The 200 copies can be delivered to the Subcommittee staff in one of two ways: (1) Government agency employees can deliver their copies to 1104 Longworth House Office Building in an open and searchable box, but must carry with them their respective government issued identification to show the U.S. Capitol Police, or (2) for non-government officials, the copies must be sent to the new Congressional Courier Acceptance Site at the location of 2nd and D Streets, N.E., **at least 48 hours prior to the hearing date. Please ensure that you have the address of the Subcommittee, 1104 Longworth House Office Building, on your package, and contact the staff of the Subcommittee at (202) 225-6649 of its impending arrival.** Due to new House mailing procedures, please avoid using mail couriers such as the U.S. Postal Service, UPS, and FedEx. When a couriered item arrives at this facility, it will be opened, screened, and then delivered to the Committee office, within one of the following two time frames: (1) expected or confirmed deliveries will be delivered in approximately 2 to 3 hours, and (2) unexpected items, or items not approved by the Committee office, will be delivered the morning of the next business day. The U.S. Capitol Police will refuse all non-governmental courier deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "110th Congress" from the menu entitled, "Hearing Archives" (<http://waysandmeans.house.gov/Hearings.asp?congress=18>). Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the on-line instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Thursday, March 1, 2007. Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office

Buildings. Those filing written statements who wish to have their statements distributed to the press and interested public at the hearing can follow the same procedure listed above for those who are testifying and making an oral presentation. For questions, or if you encounter technical problems, please call (202) 225-1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman LEVIN. Good morning. We have two buttons here. One is red and the other is green. Mr. Herger and I want to start on time, knowing that Members who have other Committee assignments, other work, will have to come in and out. Also, we have the debate on the floor on Iraq, which overshadows everything.

This is an important hearing. So, let me, if I might—Mr. Herger and I discussed briefly the procedure. We thought we would do it this way. We have two panels, the first on Intellectual Property Rights (IPR) and the second is on the subsidy issue. We have four witnesses here on intellectual property, and then I believe we have five witnesses.

So, we thought we would do this—and then the U.S. Trade Representative (USTR). We thought we would change the usual order. Usually, an Administration goes first and then the panel of witnesses. I thought often that wasn't particularly productive, that it would be useful to have an experiment where we would have the panels first and then call on the representative of USTR. That is agreeable to them, but they wanted some assurance as to time. So we told them 1:00.

So, if we leave a half an hour for not lunch but a munch, that would mean an hour and a quarter for each of the panels. If you take your 5 minutes, and we will try to abide by the five-minute

rule as we ask questions, I think that is workable, that we can do that.

We will also follow the rule that was established some years ago, and we will call on Members by the order they came in. Hopefully, that will work out. Now, for those who will come later, if they don't get a crack at you, the first panel, they will have the first crack at the second panel. Okay?

So, now Mr. Herger and I will give our opening remarks. We have looked forward to this hearing. The first panel, as I said, will be on IPR and the second will be on subsidies. China joined in December of 2001. That has been over five years ago.

When China joined, they made commitments regarding intellectual property. I am going to speak on both subjects, and then Mr. Herger will, and then we will go on. They made, as I was saying, these commitments regarding intellectual property. Unfortunately, they have not maintained or followed their commitments. We will hear from the panel testimony about the violations.

We have data that in 2005, between 85 and 93 percent of music CDs, business software, entertainment software, and movies in China were pirated, costing billions of dollars. Of course, the problem affects not only that kind of intellectual property, but also auto parts, electrical equipment, you name it, affecting businesses and workers throughout this country.

We in October of last year wrote to the Administration and urged that there be action taken through our World Trade Organization (WTO) remedies. That hasn't happened yet. So the issue becomes, why has there been this period, this half decade, of inaction by the Administration?

I am reminded of another provision under the China Permanent Normal Trade Relations (PNTR), of standard pipe under section 421. The 421 provision is a general surge provision that we inserted into PNTR so that if there was a major problem of influx of imports into this country from China, that we would have a remedy on a number of occasions.

On a number of occasions, a matter was filed. International Trade Commission (ITC) in four cases recommended action, and the Administration decided against it. Standard pipe, as I was mentioning, was one of these. In terms of thousands of net tons at the time of this attention to this important surge provision, there were being shipped by China 274,000 net tons. Just two years later—I am looking at the figures—that has more than doubled. So the price of inattention has been a very significant one.

There has been a similar problem regarding their subsidy regime. When they joined WTO, they promised to give some annual reports regarding their subsidies. It did not happen year after year after year. Finally, in 2006, they gave a report that had been required many years before.

What has happened now is that a case has been brought by the Administration, and it will testify as to that. It has brought a case against a small number of the 70-odd subsidies listed by the Chinese in the report that had been required years earlier. I think, in a word, what is happening now, after years of inattention, the Administration has filed a case but only against a relatively small number of their subsidies listed by them.

What we are doing now on a bipartisan basis is to work on legislation that essentially will apply the Countervailing Duty (CVD) law, the countervailing duty laws, to non-market economies so that companies that are being hurt by the Chinese subsidies will be able to file a complaint with Commerce, and if injury is shown, the Commerce Department will conduct a CVD investigation.

As I said, this is being worked on on a bipartisan basis. I hope that the legislation will be introduced within the next few weeks. I mention this because it is critical that we move from years of inattention and inaction to true action. Trade has to be a two-way street. Attention to subsidies is the opposite of protectionism on our part; it is really action against the protectionism of other countries.

So, we welcome this panel. The IPR panel will be first. I think you are going to give us graphic illustration of how trade hasn't worked when it has been a one-way street, and how these countries need to, as it expands trade, as we must, be sure that it operates both sides, both ways.

I now turn to you, Mr. Herger, for your opening statement.

Mr. HERGER. Thank you, Chairman Levin. I look forward to our discussion on the importance of trade with China from U.S. economy-wide perspective.

A recent Wall Street Journal editorial noted that: "China's economic growth is a dual-edged sword for its trading partners like the United States, which desires trade on fair terms but not at the price of jeopardizing entry into one of the world's fastest-growing markets."

I think this is a perspective that we must maintain, one of balance, that views China not only in terms of our trade deficit, but also its importance to our economy as a whole. China is our fourth largest export market, accounting for a 4.6 percent overall U.S. exports. Chinese exports of U.S.-manufactured goods have grown from \$9.3 billion in 1994 to \$41.8 billion in goods in 2005.

Our top export categories to China are machinery, aircraft, medical instruments, and agricultural goods, which provide jobs to tens of thousands of American workers. Although we run a deficit in trade of goods with China overall, we currently maintain trade surpluses in both agricultural goods and services. Our exports of private commercial services accounted for \$9.1 billion, including professional, technical, educational, and transportation services, supporting an estimated 37,000 U.S. jobs.

On the import end, China was the second largest supplier of goods in 2005, accounting for 14.6 percent of overall U.S. imports. The primary reason for the recent increase in the overall U.S. trade deficit in goods is the relative strength of the U.S. economy.

Strong consumer demand has led to an increase in imports, while slower growth in much of the industrialized world has limited U.S. export growth. The value of imports to our economy cannot be understated, however. They provide U.S. manufacturers the opportunity to source internationally, allowing them to maintain competitiveness by keeping final prices down. By exerting downward pressure on prices, imports lead to more choices for consumers, increasing purchasing power and real income for American workers and families, and keeping inflation in check.

The size of the U.S. deficit in goods with China is somewhat misleading because China has become a significant assembler of other countries' components. In fact, this is estimated to account for 60 percent of Chinese exports that were previously completed and shipped from other Asian countries directly to the United States.

Underscoring this point, as our goods deficit with China has increased, other East Asian imports have dropped by \$10 billion. China's economic growth has also kindled new opportunities for U.S. foreign direct investment, which reached \$16.9 billion in 2005, compared to China Foreign Direct Investment (FDI) in the United States of \$481 million.

Still, as important as China's economic growth is for our own economy, it is essential that China plays by the rules. We must see that it complies with the WTO obligations, such as protecting IPR and ending subsidies that violate its WTO obligations. To be blunt, I am disappointed at the slow pace of reform in China on these issues. While we have seen some improvement on IPR enforcement, it is not enough. I encourage the USTR to maintain the pressure.

I am pleased at the announcement that the United States is bringing a case against China's export subsidies and import substitution. This case is truly about standing up for America's workers, as has been done before on semiconductors and auto parts and in achieving positive outcomes in semiconductors and kraft liner board, by threatening cases.

In our pursuit of balance in this debate, I believe the United States must continue to press China to open its markets to our goods and services. Further, we must urge the world's most populated Nation to adopt stable, pro-growth policies which will lead to an increasingly large export market for U.S. producers and investors.

Thank you, Mr. Chairman.

Chairman LEVIN. Thank you very much.

[The prepared statement of Mr. Reynolds follows:]

**Opening Statement of The Honorable Thomas M. Reynolds, a
Representative in Congress from the State of New York**

Thank you, Mr. Chairman.

Today's hearing gives this subcommittee an opportunity to discuss an issue I've worked to highlight for several years—China's failure to protect intellectual property rights, particularly on manufactured goods.

Two years ago, the Ways and Means Committee heard testimony from Robert Stevenson, the CEO of Eastman Machines, a small- to mid-sized, family-owned manufacturer in Buffalo, New York. Mr. Stevenson vividly highlighted one of the most glaring, unfair trade practices we see from China—its blatant disregard for intellectual property rights on the patents of U.S. manufactured products.

In Mr. Stevenson's view, China's contempt for intellectual property rights is the single biggest disincentive to small- and medium-sized manufacturers seeking to export their products to that huge and growing Chinese market. In the case of Eastman Machines, which makes high-quality cloth cutting machines, the company's Chinese competitors—and in some cases, even its business partners—are pirating its designs and producing low-cost knockoffs for sale in the Far East and Pacific Rim.

When China was permitted to join the World Trade Organization in 2001, there was an implicit promise made to American businesses, workers, and consumers—that we would get a fair deal in our trade relations with the Chinese. Yet, in so many areas—intellectual property rights, currency valuation, subsidies, trade barriers, you name it—we see China failing to uphold its end of the bargain by ignoring its international trade obligations. But when companies like Eastman Machine seek

relief for their legitimate grievances, they too often find themselves getting the short end of the stick.

We need to do much more to combat China's unfair trade practices, and I look forward to working with all of my Ways and Means colleagues to push for better enforcement of our trade laws, particularly against countries like China that continually cheat on trade.

Chairman LEVIN. All right. The first panel—and I think what I will do is to introduce the four of you together, and then you will proceed. We are not being very chivalrous. We have Mr. Glickman first, but I guess we will follow that practice. I am not sure who seated you which way.

I welcome all of you, and especially welcome back Mr. Glickman and Ms. Schroeder. Both Dan Glickman and Pat Schroeder served with such distinction in this body. Your contributions were invaluable, including the sense of humor of both of you, and we miss that.

Dan Glickman went on to be, of course, a Secretary of Agriculture, among other distinguished services, and is now Chairman and CEO of the Motion Picture Association (MPAA). So, we welcome you, Dan Glickman.

Pat Schroeder, who always had a way with words—sometimes not always humorous, sometimes very much to the point, as Mr. Glickman's were—her distinguished service here has been followed by work in many pursuits, and is now President and CEO, as we know, of the Association of American Publishers. So, a special welcome to you, Pat.

Geralyn Ritter is the Vice President for International Affairs of PhRMA. We know the importance of pharmaceuticals in this country and this world. So we are especially thankful that you could come and give us your perspective.

Peter Baranay is CEO of ABRO Industries, and he is going to give us his perspective from that of a business person.

So, if each of you would take 5 minutes. Your statements will be in the record. I think the way this is working out, we will have ample time, if you can adhere to the 5 minutes, for each of us, or close to that, to have our 5 minutes. So, proceed.

**STATEMENT OF DAN GLICKMAN, CHAIRMAN AND
CHIEF EXECUTIVE OFFICER,
MOTION PICTURE ASSOCIATION OF AMERICA**

Mr. GLICKMAN. Thank you very much, Mr. Chairman. It is a pleasure to be here in this great august room. I served with both you and Mr. Herger. It is a great honor to be here, and with the other distinguished Members on this panel. I will make my comments and then be willing to answer questions afterward, but let me make the following points.

One, China is the most difficult market in the world for the U.S. motion picture industry. It is impossible to travel to one of China's major cities and not encounter street hawkers pushing pirated versions of the latest movies. I have brought many of them here with me. More than nine out of every ten DVDs in the China market is fake. A comprehensive analysis of the piracy problem estimates that our members lost \$244 million to piracy in China in the year 2005 alone.

While you can see virtually any U.S. film you want in China in pirated form, the legitimate market to American movies is one of the most restricted. The pirates have a thriving market, but our companies, who invest millions and employ hundreds of thousands of American workers, are throttled because the Chinese government decides which movies can get in or not.

These problems reinforce each other, making China nearly too frustrating to deal with. At the same time, as one of the fastest-growing markets in the world, China is indeed too potentially lucrative to ignore.

Their government has committed to fight piracy and strengthen its protection of intellectual property, but it has neither met its unilaterally announced objectives nor its international obligations.

In connection with access, we will not be successful fighting piracy in China unless we have fair access to a fair China market. That we do not have. The Chinese government needs to clean the level playingfield and remove the artificial protectionist barriers that restrict legitimate companies from supplying Chinese audiences the film entertainment they desire.

Our research indicates that almost half the pirated product is actually Chinese. We also find stolen copies of Japanese, Korean, French, and Indian movies in China. The world's film industry, including the Chinese industry, lost \$2.7 billion in 2005 in China. Half of that losses were to the Chinese film market.

In addition, our analysis of pirated DVDs from around the world trace their production back to 50 plants in China that, because of the modern global Internet and the capability of moving movies around the world, find themselves all over the world.

Let me give you an example. During my first trip to China in this role, I visited a shop near the hotel where I stayed. To my astonishment, I found a copy of one of my son's movies. My son is a film producer. I met with the Mayor of Beijing the next day. The next day, the shop was raided and closed.

During my next trip to China, I visited the same shop. It was full of more pirated disks. We alerted the authorities. It was raided again and closed.

Last December, our staff met with Ministry of Culture officials, who touted the closure of the shop and its conversion to a clothing store. The MPAA staff visited the store, and from the outside, it did look like a clothing store. However, inside in a back room, pirated versions of virtually every current U.S. movie remained available.

So, that is a key problem we face, the will and commitment of the Chinese authorities to enforce their laws. We have problems with the adequacy of many of their laws, but as strong as these laws might be, if the authorities do not enforce them, we will be no better off than we are right now.

The next problem is access to a fair market. China only permits 20 foreign films into its market each year on a revenue-sharing basis, the normal way films are distributed. Typically, U.S. audiences may have the opportunity to see as many as 20 new films over a week or two.

Those films must be imported and distributed through a government-controlled entity which dictates the terms by which we share

box office revenues, and these terms are the most unbalanced in the entire world. We also must contend with a censorship process that at times seems to be very much part of the protectionist movement over there.

In China last year, our U.S. films earned \$109 million in box office. In comparison, over the last weekend the U.S. domestic box office was \$108 million. Notwithstanding these figures, the 2006 Chinese box office was 30 percent more than 2005. Box office is moving up in China; it is just that our companies and American motion pictures are not permitted to in fact participate in that.

We spend a lot of money fighting piracy in China and around the world. We work with governments to enact and enforce the laws. We are all on the ground in China. We survey the market for information. We work with Chinese authorities on intellectual property and enforcement, and we do have some cooperation with the Chinese authorities.

The support we have received from China in actually implementing what they promise to do is indeed lacking. Our support from the Congress has been tremendous, and frankly, the work the Administration has done and is doing is invaluable in this regard.

The market is not open. The piracy rates are incredible. As you can see from all these DVDs that I brought you from a variety of movies that are not out legitimately in DVDs in the United States, all the way from "The Pursuit of Happyness," "Night at the Museum," "Babel," "Blood Diamond," "Flags of Our Fathers"—and by the way, those movies are not permitted to even be shown in China. There are only two movies on DVDs that are being permitted to be shown in China, "Casino Royale" and "Happy Feet," but again, they are not out in DVD legitimately in the United States as well.

So, I say to you that this is a problem that needs addressing. In many cases, we are the poster boy for this particular problem. There are some folks in the Chinese authorities who want to help us, but for the most part, we need your help and we need it as quickly as possible. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Glickman follows:]

**Statement of Dan Glickman, Chairman and Chief Executive Officer,
Motion Picture Association of America**

Mr. Chairman: "China is too frustrating to deal with, too lucrative to ignore." That quotation, attributed to a film industry executive, appeared in a story *Variety* carried this past Monday describing the problems the U.S. motion picture industry faces in the China market. It captures the situation perfectly, almost. For the reasons I will cite, the numbers show that China has been far from lucrative, though still a market with enormous potential.

China is the most difficult market in the world for the U.S. motion picture industry. It is impossible to travel to one of China's major cities and not encounter street hawkers pushing pirated versions of the latest U.S. movies. More than 9 of every 10 DVDs in the China market is fake. A comprehensive analysis of the piracy problem estimated that our members lost \$244 million to piracy in China in 2005 alone.

While you can see virtually any U.S. film you want in China, in pirated form, the legitimate market is one of the world's most restricted. The pirates have a thriving market, but our companies—who invest millions and employ hundreds of thousands of American workers—are throttled. The Chinese government decides which U.S. films Chinese audiences will see, when they will see them, and dictates the terms of getting those films into China.

These problems reinforce each other; they make China nearly "too frustrating to deal with." At the same time, as one of the fastest growing markets in the world

populated with audiences who genuinely like and flock to U.S. films, China is indeed “too [potentially] lucrative to ignore.”

Let me frame the three key points in the U.S.-China trade agenda from our perspective:

One, the U.S. motion picture cannot continue to absorb losses of the magnitude it suffers in China. The Chinese government has committed to fight piracy and strengthen its protection of intellectual property, for the motion picture industry as well as other U.S. copyright industries. It has met neither its unilaterally announced objectives nor its international obligations.

Two, the U.S. motion picture industry will not be successful fighting piracy in China until it has fair access to a fair China market. We are not seeking preferential treatment, we are seeking fair treatment. Movie pirates invest nothing in creating the content they peddle, yet they enjoy virtually unfettered access to Chinese audiences.

The Chinese government needs to clean then level the playing field, remove the artificial, protectionist barriers that restrict legitimate companies from supplying Chinese audiences the filmed entertainment they clearly desire.

Three, success in achieving these goals will depend, in part, on the continued support of our agenda from the Congress and the Administration.

Movie Piracy in China

Regrettably, to coin a phrase, if you did not see a counterfeit DVD, you were not in China. Too many, especially some around the world who should be allies in the fight against piracy in China, view this as an American problem, or a Hollywood problem. While we certainly bear the disproportionate brunt of the burden of this problem, movie piracy in China affects film makers all around the world.

Our research indicates that almost half the pirated product is actually Chinese. We also find stolen copies of Japanese, Korean, French, and Indian movies in China. The world’s film industry, including the Chinese industry, lost \$2.7 billion in 2005, according to the research we commissioned.

I recall a conversation with a young Chinese film producer who recently visited my office. When asked to define his number one problem, he did not mention financing, distribution, or any of the other obstacles film producers must overcome: He said piracy is his biggest problem—the theft of his movies, in China.

Movie piracy is a problem afflicting film makers no matter where they live and make movies, in more than one way. Not only are the pirates sapping legitimate movie makers in the China market, they are encroaching on legitimate markets all around the world. Our analysis of pirated DVDs seized from around the world traced their production back to over 50 plants in China.

Piracy in China it is also a problem with global reach. A pirated disc made in China can, in a day or two, be on the streets of Los Angeles. Someone can illegally camcord a movie in Montreal, send the file by way of the internet to someone in Guangzhou who then dubs and subtitles the dialogue, and then illegal presses thousands of DVDs.

In June of last year, the first research conducted in China examining the effect of piracy on the country’s motion picture industry from the perspective of industry participants revealed that Chinese film producers, exhibitors, and distributors are suffering badly from widespread film piracy, and that few are optimistic that the situation will improve any time soon.

Asked about the future of movie piracy in China over the short term, 61 percent of industry respondents surveyed in this study said they believe movie piracy will continue to increase, while 39 percent said they believe piracy levels will hold steady. No one interviewed believes that the market for pirated films will shrink.

The researchers concluded that meeting consumer demand—through increased variety and availability of legitimate movie titles as well as improved legitimate distribution networks—is to some extent a precursor of the eradication of piracy.

Over the last several months, senior Chinese officials have stepped up their rhetoric about intellectual property rights enforcement. We have seen several pronouncements of enforcement campaigns, the most recent being the so-called 100 Day Campaign launched last summer, extending through the fall of 2006.

We undertook our own survey of the effects of the campaign on the availability of pirated product. In general, we found that in some cities, in some shops, at some times, the availability declined; however, pirated discs were still available at virtually the same level. In some instances, we were asked to come back later in the day, or were squirreled to back rooms.

Let me give you an example: During my first trip to China in this role, I visited a shop near the hotel. To my astonishment, I found a copy of one my son’s movies. I met with the mayor of Beijing later that day. The next day, the shop was raided

and closed. During my next trip to China, I visited the same shop. It was full of more pirated discs. We alerted the authorities; it was raided, again, and closed. Last December, our staff met with Ministry of Culture officials, who touted the closure of the shop and its conversion to a clothing store. They visited the store, and from the outside, it did appear to be a clothing store. However, inside, in a backroom, virtually pirate versions of every current U.S. movie remained available.

Therein lies a key problem we face: The will and commitment of the Chinese authorities to enforce their laws. We have problems with the adequacy of many of the provisions of their laws. But as strong as the laws might be, if the authorities do not enforce them, we will be no better off than where we are right now.

Fair Access to a Fair Market

Unfortunately, there are several territories around the world where the rate of piracy of U.S. motion picture rivals the rates we endure in China. However, China stands unequalled in the barriers it places on the U.S. industry's ability to enter the market. Let me cite six of the most visible, and frustrating, barriers we face.

First, China only permits 20 foreign films into its market each year on a revenue sharing basis. Typically, U.S. audiences may have the opportunity to see as many as 20 new films over a week or two; China only allows 20 foreign films into its cinemas a year.

Second, those films must be imported and distributed through a government-controlled entity. We have an extremely limited role in the normal commercial activities of distributing and promoting our own films.

Third, China's state-controlled film importer and distributor dictates the terms by which we share box office revenues with Chinese theaters; these terms are the most unbalanced in the world and return to the U.S. industry rates far below normal commercial terms.

Fourth, we must contend with a censorship process that at times, we believe, can be arbitrary and motivated more by political or protectionist concerns than by making judgments about the suitability of the film.

Fifth, when we do get our films in the market, around and over these obstacles, we frequently find ourselves subjected to blackout periods, as we term them. They are periods when the Chinese authorities reserve local cinemas for Chinese films, only. To make our exclusion from cinemas even worse, blackout periods usually occur during periods, when audiences are most likely to be on holiday from work or school, such as the upcoming new year holiday.

Sixth, we also face restrictions on our ability to invest and control film production, distribution, and exhibitions businesses in China. Like other businesses, we are subject to arbitrary decisions affecting our businesses, a lack of transparency about the way those policies are set, and policies that favor local companies at our expense.

Consequently, in China last year U.S. films earned \$109 million in box office. In comparison, over the last weekend, the domestic box office was \$108 million. Notwithstanding these figures, the 2006 Chinese box office was 30% more than 2005. A recent industry analysis projected that box office revenue will double within the next 4 years.

Over the last few years, the U.S. motion picture industry has stepped up its investment in the Chinese industry. We have invested in cinemas as well as film and television production facilities. We are interested in continuing that investment; however, as we have told the Chinese authorities, we must be assured of the ability to return a sufficiently attractive return on that investment to justify it.

Some of our members have also adjusted their marketing practices to compete with the pirates. But no matter how aggressively we price our products, we cannot compete with pirates who have no investment in the content of the product and we cannot compete against the pirates who have the market to themselves, not hindered by the government regulations and restrictions we encounter.

The MPAA China Agenda

MPAA invests millions every year in fighting piracy, in China, and around the world. We go after the pirates, we work with governments to enact and then enforce adequate laws. We work to educate the public about the consequences of piracy, and the legal alternatives, and we are constantly seeking new ways to address the problem through technology, education, and changing business practices.

We are also on the ground in China. Our representatives survey the market for information about the incidence of piracy and pass on this information to the Chinese authorities. In many cases, this information helps Chinese authorities formulate cases for raids on sellers and distributors, and often, those authorities invite our representatives to accompany them on such raids.

We operate and participate in training sessions for Chinese authorities and jurists on IPR laws and enforcement, in the U.S. and in China.

We have executed a memorandum of understanding with the Chinese Ministry of Culture, National Copyright Administration, and State Administration of Radio, Film, and Television to improve protection of home entertainment products. We just recently executed, with other U.S. copyright trade associations, another agreement with the National Copyright Administration of China to enhance our collective efforts to combat internet piracy.

The support we have received from the Congress is tremendous. The work the Administration has done and is doing is invaluable.

I want to note the work, in particular, of Secretary Gutierrez and Ambassador Schwab. The Secretary has been one of our most powerful and articulate advocates; his team, here and in Beijing, are top-rate. Ambassador Schwab approaches our China agenda with a clear and forceful strategy for success, and she has deployed some of the best and most effective officials in the executive branch to our cause. We are deeply appreciative of these efforts.

In the 5 years since China joined the World Trade Organization, since taking on the obligations and responsibilities that organization demands of its members, we have, regrettably, seen little meaningful progress from China towards protecting U.S. motion pictures as the WTO requires. The market continues to be tightly controlled, in violation in some aspects of the letter of the WTO and certainly in spirit.

We will continue our work inside China, with the officials there, with the industry, and our members will likely do so, too. However, our patience and our pocket-books are not limitless.

We have walked a long way down the China road, looking and hoping for improvement. We may be nearing the end of that course and deciding on whether to take another, another which calls China into account for its WTO obligations and responsibilities, and, we believe, its failure to abide by them.

Olympic Leverage

Before coming to my current position, I spent a fair amount of time in China and working on matters affecting China while I was in Congress and as Secretary of Agriculture. In particular, with respect to the latter, I was deeply involved with President Clinton in fighting, successfully, for PNTR for China.

When I traveled first to China under the MPAA mantle, I was greeted as a friend of China for that work. I was able to secure meetings at the most senior levels and enjoyed candid and productive conversations with those officials. Since then, I have worked hard to maintain good relations with the Chinese government and industry.

In addressing our problems with the Chinese officials, I told them that I am struck by the fact that when, and if, they want to protect intellectual property, they can be remarkably successful. While fake DVDs litter Beijing, fake Olympic-logo materials are impossible to find. The government has made it abundantly clear that it will not tolerate Olympic rip-offs, and it has enforced that edict, effectively. In sum, when the Chinese authorities want to protect intellectual property, they can.

As the world's eyes begin to turn to Beijing in the run-up to the 2008 Olympics, I have asked the authorities if they want the world to see a China of which they can be proud, or do they want the world to see a China of fake DVDs—a China which pays no heed to intellectual property, a China which countenances theft, theft of ideas, creativity, and of the livelihoods of the working men and women who make those movies.

My views on how we can use the pressure of the Olympics to further our agenda are explained more fully in the attachment to this statement. In your discussions with Chinese officials, I urge you to make the same points. I believe we must step up enforcement, open the market, possibly take legal action at the WTO, and we must also shine the powerful light of world public opinion on the Chinese.

Mr. Chairman, I appreciate the fact that you have decided to call attention to our China problems as one of the first matters on your agenda this Congress. I look forward to your questions and to working with you and your colleagues in advancing our agenda in China.

Thank you.

Is China ready for its close-up?

As the world focuses on the Beijing Olympics, will the government drop the curtain on entertainment pirates?

By Dan Glickman

From: The Los Angeles Times

AS BEIJING begins preparing for the 2008 Olympic Games, we will see more and more of the Olympic logo, one of the most widely recognized pieces of intellectual property—and one of the best protected.

To be sure, fake depictions of the five rings and the logos of individual Games have plagued the International Olympic Committee and host country Olympic committees. But the integrity of the logo will be tested like never before when the torch enters Beijing.

China is arguably the world's largest marketplace for pirated goods—from copied luxury items and medicines to bootleg versions of the latest films. Will knockoffs of Beijing's running-man logo for the 2008 Games become as commonplace?

A recent news story cited a Chinese manufacturer who observed that his government was implementing strict control over the production and distribution of Olympics materials “to protect the value of the logo”—and it's working. Will China translate its apparent will to protect the integrity of its Olympic logo to movies, music, publications, television, entertainment and business software, pharmaceuticals and other industries that are built and dependent on effective protection of their intellectual property?

In a little less than two years from now, hundreds of thousands of people will travel to China for the Games that billions of people will watch on television. I know the kind of China I want them to see: a responsible great power, a leading player in the world's affairs abiding by the rules of the community of nations. I also want to see China as welcoming of movies and other entertainment from around the world as the government will be of fans and athletes from around the world.

Indeed, China has actively sought such recognition, most pronounced in its successful bid to join the World Trade Organization. Along with recognition, that membership carries responsibility, a duty that China has failed to meet in opening its market to legitimate entertainment industries and protecting intellectual property and the value of creativity. This deficiency is not just an intolerable burden to the U.S. motion picture industry; it afflicts filmmakers worldwide, including those in China. An independent Chinese film producer recently told me that his single biggest problem is the piracy of his work by his fellow countrymen.

During my last trip to China, I heard from Chinese officials—all too frequently—that the rest of the world must be patient, that we must give China more time to develop a sophisticated, comprehensive and effective system of protections for intellectual property rights. The authorities said that modern China has a mere 20 years experience—a small fraction of that of the United States.

I reject this explanation. My first trip to China was more than 20 years ago. The transformation of the nation and its economy since then has been astonishing, made possible by a commitment to purpose and a purposeful will—both of which have been lacking in its approach to intellectual property rights. Although China has opened itself to the world in many remarkable ways, the U.S. motion picture industry still faces a bewildering array of restrictions, hobbling its fair access to China's market. At the same time that China effectively permits pirates unfettered access to Chinese movie consumers—93% of the film market is pirated goods, according to Motion Picture Assn. of America research—it severely restricts the ability of legitimate moviemakers who have invested enormous capital in producing the filmed entertainment that the pirates steal. This gives the pirates a monopoly.

I challenge Beijing to use the 2008 Games to showcase a new commitment to movie rights. Beijing has enlisted the help of some of the greatest American film directors to create projects to showcase China and the Olympics. Yet these same directors have repeatedly had their films rejected for exhibition in China. But make no mistake, their films are widely known and viewed in China, thanks to the sales of millions of pirated DVDs.

In 2008, the world could see China as a nation of fake goods, a nation running roughshod over respect for intellectual property. Or it could be seen as a respected member of the international community that welcomes a diversity of entertainment products while protecting and valuing the integrity of intellectual property.

China is a great power. Will it act like one?

FOOTNOTE

The Motion Picture Association of America (MPAA) represents the major U.S. producers and distributors of motion picture and television programs; its members are NBC Universal City Studios, Paramount Pictures Corporation, Sony Pictures Entertainment, The Walt Disney Company, Twentieth Century Fox Film Corporation, and Warner Bros. Entertainment

Chairman LEVIN. Thank you very much.
Pat Schroeder. Welcome.

**STATEMENT OF PATRICIA SCHROEDER, PRESIDENT AND
CHIEF EXECUTIVE OFFICER, ASSOCIATION OF AMERICAN
PUBLISHERS**

Ms. SCHROEDER. Thank you. It is so wonderful to see Chairman Levin and Chairman Herger—or Ranking Member Herger up there. Both of you got great promotions. It is great to see all of my friends up there. Those of us who weren't on Ways and Means are always in awe when we are in this room. So, I will try not to be too awestruck.

Thank you for——

Chairman LEVIN. It may not last long.

Ms. SCHROEDER. Yes. Yes.

Mr. CROWLEY. Mr. Chairman, can I also say that so are we.

Ms. SCHROEDER. That is great. Well, I want to say for the book industry—we know. You earned it.

Chairman LEVIN. All right. We won't take that away from your 5 minutes.

Ms. SCHROEDER. Terrific. Well, I just want to say for the book industry, we really thank you for including us. America's book industry is about a \$25 billion industry. It is very, very large. We have all the same problems of the movie people.

Obviously, our publishers desperately want to get into the Chinese market and have not been able to. That's not just talk—people say, of course you want to get in, but last January 30th, or this January 30th, Danny and I and some other copyright folks were over here on the Hill releasing the 2005 statistics on the copyright industries in America.

I just want to remind people, we are over 11 percent of the gross national product of this country. We are one of the major exports of this country. What we also showed is that the wages of the average person in copyright was 40 percent over the average worker in America. These are the middle class wages Americans want, and we really think that intellectual property is where America's future jobs are in this global economy. So, we really need to work together to protect them.

Obviously, we can't get into the Chinese market as long as they keep cratering that market with this rampant piracy that our book industry is up against. We have no idea what the true value is. We estimate just for higher ed, it is conservatively \$52 million.

We are also getting hit very hard by digital piracy, the downloading of entire books. Digital piracy is growing by leaps and bounds. We have no estimate for how broad-based that is, nor do we know how deep it is for all of the general pirated books that we have out there, just the regular market books.

Let me say what we are working on first in China is the schools. Universities are reproducing entire books. They do it at the university. They often put their stamp on it. Sometimes they put hard covers on it. Obviously, the Chinese government has to know about this. This is very shocking to us. That is where we really can get some figures as to what piracy looks like. So, American publishers are trying to educate the Chinese, but we are not getting paid for any of our textbooks being used everywhere. It is really kind of strange.

Then obviously, just as Danny had, all of our book publishers find their books over there, and that is very frustrating. We have no idea the value of overall piracy of books in China. Kite Runner, Bill Clinton, they are all out. You can buy illegal copies on any corner.

Then they do trademark piracy, too. Harvard University has got so many books over there with the Harvard symbol on it, and other universities are the same. All the books are frauds. They are all total frauds. One of our favorites even had a recommendation from Einstein. It is pretty hard to give a recommendation from the grave, but nevertheless, that is what is happening.

So, we have been very frustrated by this problem. We work with the local Chinese publishing association. They are equally as frustrated by it. We had a gigantic conference on piracy at the international Beijing book fair in 2005. Interestingly enough, right out on the street in front they were selling pirated books, so clearly, the pirates aren't worried about any kind of enforcement at all if you can do it right outside the book international show.

So, finally, we have gotten the Chinese to pay a little bit of attention. They raided some universities. They raided six of them. Many of them they raided when universities were closed down, so obviously, they didn't find much. Secondly, if they did find much, the fines were so de minimis it didn't mean a lot, but at least it was an attempt. It is kind of the frustration that you talk about. They have put out some memos saying, thou shalt not do this. Well, will they follow up? Will they really pursue that? We don't know.

We have been working with our Government. Our Government desperately needs to help. As I say, we work with the local industry. We talk to the Chinese officials. We keep pushing, but we don't seem to get very far.

Finally, book publishers can't even get into the Chinese market. Under the WTO Agreement, they were supposed to be allowed in, but we are not allowed to import our own books in the legitimate market at all. No American publisher are allowed unless they align themselves with a local government official or a sanctioned publishing house. Our publishers are not allowed to set up and publish internally. Nor can our publishers distribute. We can't bring them in. We are shut out of the market. We want to be in the market. We see our stuff being sold and pirated all over the market. So, that is it. Thank you very much, Mr. Chairman.

[The prepared statement of Ms. Schroeder follows:]

**Statement of Patricia Schroeder, President and Chief Executive Officer,
Association of American Publishers, Inc.**

The Association of American Publishers (AAP) thanks Chairman Levin and the Ways and Means Trade Subcommittee for the opportunity to participate in today's

public hearing on the matters related to the protection of intellectual property rights in China. The pervasive problems of copyright piracy and trademark counterfeiting in China, exacerbated further by severe restrictions on market access for several industries including publishing, are some of the most important issues facing China and the U.S. today.

About AAP

The Association of American Publishers is the national trade association of the U.S. book and journal publishing industry—an industry with 2006 sales exceeding \$25 billion. AAP's more than 300 members include most of the major commercial book publishers in the United States, as well as smaller and non-profit publishers, university presses and scholarly societies. AAP members publish books in every field, educational materials for the elementary, secondary, postsecondary, and professional markets, scholarly journals, computer software, and electronic products and services. The protection of intellectual property rights in all media, the defense of the freedom to read and the freedom to publish at home and abroad, and the promotion of reading and literacy are among the Association's highest priorities.

Introduction to Book and Journal Piracy in China

In 2006, AAP estimated losses to U.S. publishers in China at \$52 million, not including losses due to piracy on the internet. Visits to China and discussions with our member publishers reveal a staggering amount of book piracy plaguing this most promising of markets.

Book piracy manifests itself in a number of different forms in China. Illegal commercial scale photocopying of academic materials is the industry's most immediate concern. Print piracy (unauthorized reprints approximating the quality and appearance of the original) and illegal translations have profound effects on the market as well. Internet piracy in the form of sites offering illegally scanned books for download, peer-to-peer trading and unauthorized access to electronic journals and other database compilations, is growing by leaps and bounds. Furthermore, trademark counterfeiting, especially with regard to books produced by university presses, misleads Chinese consumers. All of this is exacerbated by market access barriers that deny foreign publishers the ability to freely import into the Chinese market, distribute their own materials, obtain local Chinese book publication numbers or print for the local market.

- *Commercial photocopying*

One of the most destructive forms of book and journal piracy is commercial-scale illegal photocopying of academic materials, an activity that takes place on and near school and university campuses all over the world. The mechanisms differ slightly from place to place. In some cases, most of the photocopying takes place at small copyshops lining the campuses. These shops often appear to be minute, independent operations, but in reality are frequently linked in ownership and highly organized. Campus facilities are often used to make illegal copies as well, including library books, copiers in libraries, student centers and academic buildings and commercial operations leasing space on the premises of the institutions.

In China, this is taken one step further. Almost every Chinese university has at least one "textbook center" on campus, in most cases run by the university itself and charged with distributing textbooks to students at the start of each term. In some cases, these textbook centers are distributing legitimate texts, legally printed or imported for the use of the students. In the vast majority of cases, however, these centers are distributing photocopied or illegally printed texts in large quantities. These illegal copies are generally made on the campus—at or near the textbook center, presumably at the request of the university authorities or the lecturers adopting the books. It is often a highly organized practice, complete with stock lists, storage warehouse, bar codes and colorful covers bearing the name of the department or the university crest.

It is important to note two things when discussing these textbook center practices. First, being mindful of the notion of "fair use" or "fair dealing" in academic materials—legal provisions stipulating that a certain amount of copying is permissible for purposes of private study or research—I must emphasize that the copying taking place at these textbook centers far exceeds the possible bounds of fair dealing. Routinely, books are copied in their entirety. Large portions of books or journals included in "compilations" go well beyond "fair use" as well. AAP respects the balance reflected in the fair use provisions contained in international agreements. These practices, however, disrespect that balance greatly. Second, it is important to recognize that these textbook centers hurt Chinese publishers just as much as foreign publishers. Many of the illegally copied books found in textbook centers are Chinese

language, Chinese published books. This results in massive losses to a local industry that is trying to establish itself in an international marketplace.

The practices of these textbook centers, undertaken with either the tacit or active consent of the universities themselves, are destroying the market for English and Chinese-produced textbooks alike. AAP and the Publishers Association (PA), its sister association in the U.K., have been working with authorities in the General Administration of Press and Publication (GAPP), the National Copyright Administration of China (NCAC), regional copyright authorities and the Ministry of Education (MOE) to bring light to these issues.

- *Print piracy and translations*

Print piracy and unauthorized translations have a profound effect on the market as well. Bestsellers such as the Harry Potter® series, Dan Brown's novels and political autobiographies are pirated in English and Chinese within days of their home country releases. These books—of varying quality—are readily available in retail markets and street stalls, apparently without fear by the vendors of any government action. AAP representatives have routinely seen pirate books sold by street vendors outside the Beijing International Book Fair venue! Clearly, the boldness of the pirates suggests that enforcement measures to date have not been effective.

Until a few years ago, print piracy of all books was the prevalent form of piracy in China. This was due, in part, to the high cost of photocopy paper and implements—it was more profitable to undertake an entire print run of a bestselling commercial or professional book. While photocopying has caught up and perhaps surpassed this problem in prevalence, the issue of print piracy remains significant. Print piracy's effects are especially severely felt among publishers of high-end technical books, reference books and English language teaching books, as well as commercial fiction.

Print piracy exists primarily in two forms. The first involves print overruns by an otherwise legitimate Chinese printer. This licensing issue is exacerbated by the market access restrictions in place (see below) that prevent U.S. publishers from engaging in direct contracts for printing for the Chinese market. Instead, U.S. publishers must partner with a Chinese publisher, who handles all contracts for book production. This lack of control over the contractual relationship makes it difficult for U.S. publishers to control licensees who violate the contract terms by printing more copies than licensed and selling the "rogue" copies for an extra profit. They then return the unsold legitimate copies to the publisher, who bears the full risk of estimating market demand under the industry's "remainder" system. Foreign publishers will remain vulnerable to this practice until market access barriers as to printing are removed.

The second form is outright piracy by an entity that has no license to print the book at all. In some cases, book pirates target an English language book that they are able to replicate almost exactly, thus being able to print a book that is virtually indistinguishable from the original. In other cases, books are clearly pirated—the quality varies greatly. Most translation piracy involves print piracy of this type—often, poor quality translations, bound at a printing press. This hurts not only the original foreign publisher, but also the Chinese publisher who was granted the legitimate translation rights.

Recent studies suggest that underground dealing of pirated bestsellers, especially at places such as the Beijing Book Market in Tianshuiyuan, is flourishing. AAP suspects that Tianshuiyuan is the primary source for pirated books sold in the street vendor network in Beijing.

- *Internet piracy*

The industry's fastest growing problem—a problem we share with many of our fellow copyright industries—is internet piracy. Just in the last six months, complaints from publishers about scanned books being traded online have increased significantly. Clearly, this is a practice that threatens to do more harm to our industry than all other problems combined.

Web sites offering free book downloads are thriving. These books in most cases do not originate in electronic form, but are scanned versions of hard cover books. Sites offering pay or free downloads join traditional peer to peer trading sites as serious threats to the book market. Too often, takedown notices are ignored and government action against these operations is slow.

Internet piracy is affecting publishers of academic and professional journals in a different way. These journals, which unlike most of the books originate in electronic form, are usually made available by publishers to institutional subscribers through use of passwords or similar "gateway" mechanisms. Increasingly, journals publishers are seeing evidence of these electronic "gateways" being left open or accessed

by unauthorized users. Publishers have also reported evidence of abuse of “trial” samples of electronic goods sent to libraries through extensive unauthorized sharing of these samples among institutions. All of this activity—in violation of both copyright laws and subscriber agreements, opens the doors for pirate operations to access these materials, reproduce them and sell them in competition with the legitimate vendors.

Electronic piracy is in some cases replacing photocopying as well. Reports indicate that often, scanned versions of academic titles are reprinted and bound for distribution by second hand bookstores, with the label “e-book.” Indeed, this is an increasingly frequent phenomenon throughout the world, as more and more enforcement actions against traditional copyshops are yielding computers full of “e-files” ready to print at customer demand.

- *Trademark counterfeiting*

While most book publishers are primarily focused on copyright piracy, trademark counterfeiting affects the industry as well. Counterfeiting is often incidental to copyright piracy, as pirates use the famous imprints of American publishers to get attention from readers. This is taken to a new level when well-known publishers’ names are used on books that bear no content produced by that publisher at all! These books, available at mainstream bookstores in China, mislead consumers as to the origin of their content.

In addition, book publishers suffer from a sort of “passing off,” by which books bearing titles and fictional authors’ names similar to bestsellers are marketed at the expense of the legitimate authors and publishers. By one example, former President Bill Clinton’s book was marketed, before release in China. One version contained long excerpts of Senator Hillary Clinton’s book in place of President Clinton’s writings.

- *Market access*

One will never effectively tackle a piracy problem without ensuring that legitimate product is available for the market in question. We cannot divorce the concept of market access from the question of piracy. In no case is this more apparent than in China. Activities essential in the publishing chain of events are off-limits to foreign publishers. Many of the restrictions in place violate the commitments China made in acceding to the World Trade Organization (WTO). For instance, foreign publishers cannot import, hold stock and distribute their own materials in the Chinese market, resulting in delays in delivery and increased costs. Some of these activities are restricted to State-owned enterprises; others are limited in such ways as to keep them effectively entirely closed. Foreign owned enterprises are also prohibited from making final decisions about content to be published in the market, or obtaining the necessary Chinese book number that is a prerequisite for publishing in China. Foreign publishers cannot print for the Chinese market, but only for export. AAP believes wholeheartedly that, in order for publishers to be able to tailor a product to the market—in substance and in price—foreign publishers must have greater access to the market than they do today.

Publishers understand the needs of a local government to exercise some degree of content control, and remain willing to abide by China’s censorship process. Yet, the censorship process should not be coupled with such severe restrictions on activities in the market.

Market access issues affect the ever-growing market for online content as well as hard goods. High fees charged for access to foreign material on the China Education and Research Network (CERNET) result in high costs to publishers of electronic materials (such as academic and professional journals) in making their products available in China, and fewer, lower quality options available to Chinese scholars and students.

China’s lack of transparency with regard to the laws and regulations governing market access further exacerbate an already frustrating situation. This must be improved. AAP calls on China to increase its transparency with regard to all provisions pertaining to implementation of its obligations under international agreements.

Industry Efforts and Activities

AAP, along with the Publishers Association of the U.K. (PA), has been working hard to engage the relevant Chinese authorities on the various issues facing the industry. The association has worked extensively with the National Copyright Administration of China (NCAC), the General Administration of Press and Publication (GAPP), the Ministry of Education (MOE), the Ministry of Information Industry

(MII) and regional copyright authorities to address the problems of illegal reproduction at university textbook centers and internet piracy.

Between June and October 2006, NCAC and GAPP, together with regional authorities, investigated and took action against textbook copying at six universities, including some of Chinese most prestigious institutions. These organizations and the Ministry of Education also issued a series of notices to be disseminated to universities mandating that the infringing activities be halted. AAP and PA are working with authorities to verify the effects of these notices and actions. Since copying of academic materials in particular is cyclical in nature, it is especially important that the authorities monitor campus activities at the beginning of the academic terms. The starting points of classes this year—in March and September—therefore present excellent opportunities for the Chinese government to show that it is serious about stopping this form of piracy.

In addition, AAP and the PA are working with NCAC, MII and regional authorities to ensure that sites infringing our materials receive adequate attention. The associations have had at least one early success but progress has been slow on a second complaint.

These enforcement efforts have been complemented by a number of educational programs and dialogues that have allowed foreign and local publishers to join voices in the fight against piracy. On May 19, 2006, AAP and PA partnered with the Publishers Association of China (PAC) to bring a dialogue on these efforts to BookExpo America, the largest book publishing trade show in the United States. The program featured speakers from the GAPP, the Chinese Institute of Publishing Science, the U.S. Patent and Trademark Office, the Office of the U.S. Trade Representative and many industry bodies from China, the U.S. and the U.K. AAP was pleased to see the recognition that piracy is a common problem affecting many economies and a host of book-related industries.

The May 19 program followed a groundbreaking event held at the Beijing International Book Fair in September 2005. Also cosponsored by the Chinese, British and U.S. publishing associations, the program was entitled “Intellectual Property in the Global Economy: China’s Place in the World Publishing Community” and featured speakers from the U.S. Embassy Beijing, the NCAC, the GAPP, the Beijing Municipal Copyright Bureau, Renmin University, the Chinese Academy of Social Sciences and several publishing associations and companies. Again, all came away with the clear conviction that there was a common goal to pursue.

Conclusions and Industry Suggestions

The industry is working hard to inform itself, speak to the authorities and make a dent in this landscape of piracy. AAP and its members firmly feel, however, that government-to-government dialogue is essential in bringing about meaningful change in the Chinese market place. We encourage the Administration and Congress to keep engaging the Chinese government in a variety of venues, consistently emphasizing the need for strong intellectual property rights protection for China’s local industry as well as foreign industry, and the need for greater market opening in this sector so important to Chinese culture and scholarship. China is a country that boasts millions upon millions of eager potential readers and scholars, and these readers are largely being supplied with illegal goods.

AAP asks that government-to-government discussion of book piracy—including in the Joint Commission on Commerce and Trade (JCCT) talks, the Strategic Economic Dialogue (SED), and other appropriate venues be stepped up. AAP also joins its fellow copyright industries in asking that the U.S. government continue to pursue strong laws and regulations governing internet infringement, in hopes of saving the market from utter destruction by file-sharing and downloading sites. Third, AAP emphasizes the need for more effective enforcement against hard goods pirates, through the administrative, civil and criminal systems. Finally, AAP stresses that market access for foreign companies is imperative in the fight against spreading piracy, that transparency of laws and regulations affecting both market access and intellectual property protection must be increased and that China must bring its laws and regulations into compliance with the commitments it made upon acceding to the WTO. AAP looks forward to working with all relevant parties to ensure that the market becomes increasingly viable for legitimate businesses.

Chairman LEVIN. Thank you so much, Ms. Schroeder.
Your turn. Thanks.

**STATEMENT OF GERALYN RITTER, SENIOR VICE PRESIDENT
OF INTERNATIONAL AFFAIRS, PHARMACEUTICAL RE-
SEARCHERS AND MANUFACTURERS OF AMERICA**

Ms. RITTER. On behalf of PhRMA, I would like to thank you very much, Mr. Chairman and other Members of the Subcommittee, for organizing today's hearing and giving us a chance to speak about this very important issue.

IPR drive innovation in the biopharmaceutical industry, and that is what makes possible the development of new medicines for patients around the world. Nowhere, I think, is that more important and more under threat than in China.

My testimony today is going to focus on two of our top issues. That is pharmaceutical counterfeiting, and also the absence of reliable clinical test data protection in China.

Pharmaceutical counterfeiting is an intellectual property (IP) enforcement concern, of course, but first and foremost, it is a safety concern. Counterfeit medicines take several forms, but in every form they are dangerous. Some of the most insidious counterfeits actually do contain chemical compounds that are the same as the legitimate product, but in quantities that are far too high or often far too low, both of which can cause serious effects.

Oftentimes the counterfeits are just sugar pills. They are placebos, with no active ingredients at all. Of course, the worst kinds of counterfeits are pure poison, and even one of those, I think we can all agree, is too many.

The Chinese government has undertaken a series of actions to try to deal with this problem. Raids and seizures are up in 2006, but still, China remains the number one global source of counterfeit medicines in the world.

They have got two real, serious weaknesses in their regulatory scheme that cause us a lot of problems and hamper enforcement in China. The first is that even though the laws prohibit fake medicines, criminal liability is generally conditioned on showing some sort of actual harm to a patient. So, if you become aware of a shipment of counterfeit drugs and stop it before it actually reaches the patient and hurts someone, then you have just made it far harder to get a criminal conviction.

A much better way to deal with drug counterfeiting in China would be for the Chinese government to amend its drug laws to make it a crime to manufacture or distribute any medicine that is deliberately mislabeled. It shouldn't matter how much, and it shouldn't matter whether or not someone has actually been hurt yet. If you make a drug and you call it something that it is not, that should be a crime, full stop.

China also needs to improve coordination among their various government agencies that have oversight and enforcement responsibilities in this area. They need to make sure that those agencies have sufficient authority and resources to prosecute every link in the counterfeiting supply chain.

Which brings me to my second point on counterfeiting. There is a missing link in enforcement against counterfeits in China, and the missing link is the very first one, the most upstream producers. Chemical manufacturers in China are freely selling and shipping the active pharmaceutical ingredients, the bulk chemicals that

make a medicine work, within China and around the world with no oversight by that country's food and drug authority.

This is important because these are the chemicals that are sold to the downstream counterfeiters that may process them into pills or tablets for worldwide distribution, but at present, although the authorities can go after pharmacies and other distributors, and even the manufacturers of the finished product, it is far more difficult and they don't really have good legal authority to go after the chemical companies that are supplying those counterfeiters. So, China's law needs to be amended so that those chemical companies that produce the unregulated active ingredients are subject to far more stringent regulation.

The second major IP problem that we are facing in China relates to clinical test data protection. When China joined the WTO in 2001, they promised to do this. They revised their laws and indicated that they would be enforcing Trade-Related Aspects of Intellectual Property Rights to protect the client test data that is submitted when a drug application is filed. Unfortunately, the way they have implemented those laws has made that protection meaningless and works to provide an unfair advantage to local Chinese companies.

What is supposed to happen is that when an innovator files an application for a new drug at the Chinese Food and Drug Administration, the test data that takes years and millions of dollars to develop to prove that the drug is safe and effective is supposed to be protected for a period of time so that no other company can rely on that data until the protection expires.

What happens in reality is that an innovator files its data for a new drug, often in the United States first, and almost instantly multiple Chinese companies are filing for approval in China based on a reference to the U.S. data. The result? Multiple Chinese companies entering the market at the same time as the innovator with the same product based on the same data and no period of protection at all.

So, let me sum up here and say that PhRMA Members are committed to the Chinese market. We are committed to Chinese patients. We want to work and we do work with the Chinese government to address these problems, and we have appreciated the support we have received from the U.S. Government, but the problems are very serious and they remain. We look forward to working with you to try to provide a better business environment for U.S. companies in China. Thank you.

[The prepared statement of Ms. Ritter follows:]

**Statement of GERALYN RITTER, Vice President of International Affairs,
Pharmaceutical Research and Manufacturers Association**

On behalf of the Pharmaceutical Research and Manufacturers of America (PhRMA), I thank Chairman Levin and the Subcommittee members for organizing today's hearing on intellectual property rights enforcement in China. Intellectual property rights drive innovation in the bio-pharmaceutical industry and enable the development of new and improved medicines for patients. PhRMA strives to uphold and defend these rights around the world. China is no exception.

My testimony will focus on the top three IP concerns for our industry in China: Specifically, pharmaceutical counterfeiting, protection of clinical data and patent reform. We estimate that the economic damage resulting from poor IP enforcement costs the industry approximately 3.4 billion dollars in lost sales annually. This is,

in fact, a conservative estimate because it only captures quantifiable losses due to the lack of patent protection and data exclusivity for many products. It is impossible to know what percentage of the legitimate pharmaceutical market in China is supplied by counterfeits.

Pharmaceutical Counterfeiting

While the Chinese Government has undertaken a series of actions to combat drug counterfeiting, the prevalence of counterfeit drugs within and originating from China nevertheless remains a substantial concern. Indeed, China is believed to be the world's leading exporter of counterfeit drugs and bulk chemicals.

Although pharmaceutical counterfeiting is subject to criminal, administrative and civil remedies under China's trademark laws, the effectiveness of such remedies is undermined by burdensome evidentiary requirements and weak enforcement. Anti-counterfeiting efforts are hindered by the general reluctance of administrative authorities to impose deterrent penalties and transfer cases to criminal authorities. Moreover, border enforcement is undermined by excessive bond requirements, a lack of transparency and short filing deadlines.

Significant weaknesses in China's drug safety regime contribute to the proliferation of counterfeit pharmaceuticals in China and the global export of inherently dangerous products. Pharmaceutical counterfeiting is first and foremost a drug safety violation. Thus, the adequacy of China's response to pharmaceutical counterfeiting must be measured against the framework of laws that regulate the various links in the drug manufacturing and supply chain. In that regard, China has yet to enact laws that address all aspects of drug counterfeiting activity or to provide the kind of enforcement resources and commitment necessary to combat this growing problem. For example, although China's drug laws prohibit "fake" medicines, criminal liability is conditioned upon proof of harm, a statutory requirement that, in practice, requires evidence of a serious defect in quality. This burdensome and excessive evidentiary requirement all but precludes criminal prosecution against counterfeiters under China's drug laws.

Another significant deficiency is the fact that China's drug regulatory authorities lack sufficient investigative powers and resources to take effective action against upstream manufacturers and suppliers. As a result, regulators are forced to rely upon criminal authorities to target counterfeiters; as noted above, however, criminal authorities are hamstrung by excessive evidentiary requirements. The net effect is a system of drug safety laws that provide no meaningful deterrence against the manufacture and distribution of counterfeit pharmaceuticals. Moreover, once counterfeit drugs reach the border, there are virtually no checks in place to prevent their export to other markets.

To rectify these problems, it is imperative that China amend its drug laws to prohibit and criminalize the manufacture, distribution, import or export of any pharmaceutical that is deliberately mislabeled as to source or identity (consistent with the WHO definition of a counterfeit medicine), without the need to prove harmful effects or deficient quality. In addition, China should create an interagency, pharmaceutical task force of law enforcers, regulatory authorities and customs agents to ensure adequate coordination among the various authorities with relevant oversight and enforcement responsibilities. Each of these officials must be given the investigative powers and mandate to prosecute all links in the counterfeit drug chain, including manufacturers, wholesale and retail distributors and exporters of counterfeit medicines and related packaging and raw materials.

An important factor contributing to the pervasiveness of drug counterfeiting is that Chinese chemical manufacturers are producing bulk active pharmaceutical ingredients (API) which are being used in the manufacture of counterfeit drugs.

China has thousands of chemical companies, and there is evidence that some are producing and selling API in bulk form to downstream counterfeiters, often via the internet. The downstream manufacturers further process the chemicals into counterfeit pills and tablets sold within and outside of China, including the United States. Unfortunately, under current Chinese law, the chemical suppliers who are conducting such activities are not operating illegally under Chinese law.

According to Chinese Drug Administration Law, a chemical company is subject to government oversight by the SFDA when it "chooses" to register a specific API product with SFDA. It is only when the chemical company declares that it is making an API to be used in a finished pharmaceutical good and after the SFDA grants a product registration number that the company is legally permitted to supply API for inclusion in a finished pharmaceutical product. Under the current regulatory framework, if a chemical company manufactures an API, but elects not to declare that the API will be used in a finished pharmaceutical good, there is no government agency that possesses authority to preclude this activity from occurring.

The SFDA recognizes the importance of patient health and safety by regulating chemicals that will be used in finished pharmaceuticals. However, clear evidence exists that chemical companies are ignoring SFDA requirements by advertising their API products on commercial websites in the bulk form under the category of “(for) medicinal use” while not adhering to SFDA GMP regulations. Chemical manufacturers are freely selling and shipping API products to locations within China and abroad with either no regard for the intended use of the API or flagrantly choosing not to comply with existing Chinese regulations that would bring them under the oversight of the SFDA. These unregulated and unethical practices by chemical companies contribute significantly to, and, in some cases, aid and abet the counterfeit drug trade.¹ More troubling is that the unregulated distribution of API exposes patients to serious and significant health risks as well as degrades consumer confidence in the global medicinal supply chain.

Addressing the Most Prevalently Counterfeited Medicines

PhRMA recommends that the SFDA impose special requirements on the API substances of the 10 most commonly counterfeited pharmaceutical products in China (the “Listed API Product(s)”) according to the data compiled and updated jointly by SFDA and the Ministry of Public Security on an annual basis. SFDA could require all chemical companies manufacturing one or more of the Listed API Products to comply with all SFDA Good Manufacturing Practices (GMP) requirements, as if it were to be used in a legitimate finished pharmaceutical good.² Additionally, SFDA could require that the chemical companies certify that they will maintain detailed records of the recipients of each shipment, the quantity, the intended use of the Listed API Product being shipped and the Business License showing the business scope of the recipient. These records could be made available to SFDA officials should they ask to review the records. If the chemical company fails to maintain appropriate GMP, provides a false certification and/or fails to keep accurate records, the SFDA should have the authority to impose deterrent penalties, including a fine and a notice of its violation to the local Administration of Industry and Commerce (AIC) to whom the chemical company is registered and the possible revocation of the company’s operating license should multiple violations occur.

PhRMA supports the formation of a working group between industry, SFDA, the Ministry of Commerce and the Ministry of Public Security to address the problem of counterfeit API and to discuss the proposal outlined above.

Clinical Data Protection

Following accession to the World Trade Organization in 2001, China revised its laws to incorporate concepts from Article 39.3 of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Article 39.3 provides that a country must protect data submitted in the context of a drug registration application from unfair commercial use. Loopholes in China’s current regulatory environment allow for unfair commercial use of safety and efficacy data generated by PhRMA member companies.

One such loophole exists because China defines “new drug” as any drug not previously marketed in China. Chinese domestic companies can file a “new drug application” for approval of a compound if that compound was previously approved by a regulatory agency in another country. Although the SFDA requires some limited clinical data on local populations for drug marketing approval, it relies heavily on published material generated by originator companies in the country of first launch. The published data, however, is insufficient by itself to prove the safety and efficacy of the product. But for the full clinical dossier that was submitted to the FDA in the U.S. or EMEA in Europe, China would not grant marketing approval on the basis of the limited clinical data required for regulatory approval. This is evident from the fact that China distinguishes products that have never received marketing approval anywhere in the world from those that are simply “new to China.” Products that have never been approved anywhere in the world require considerably more safety and efficacy data than products that have received prior marketing approval.

¹ Under U.S. law, a supplier of active ingredient for a drug that will be marketed in violation of the Federal Food, Drug, and Cosmetic Act (FDCA) may, if the supplier is knowingly involved in the illegal activity, be charged with a conspiracy to commit that offense, 18 U.S.C. 371. In addition, the supplier who knowingly helps its customers in violating the counterfeit prohibition could be charged for aiding and abetting a violation of a U.S. federal statute, 18 U.S.C. 2.

² Active Pharmaceutical Ingredient (API), for this purpose, should include those components and intermediates of the product that may undergo chemical change during the manufacture of the drug product and be present in the drug product in a modified form intended to furnish the specified activity or effect.

PhRMA views China's deference to published material and regulatory decisions by agencies outside of China as reliance on clinical data developed by originator companies. The published data alone are usually insufficient to prove the safety and efficacy of a product. The published data merely summarize the data included in the original filing. The original data were necessary to demonstrate the safety and efficacy of the product. Reliance on summary data or approvals in countries outside of China conveys an unfair commercial advantage to non-originator companies because non-originator companies do not incur the cost of generating their own clinical data.

In practice, the SFDA receives numerous applications for marketing approval of a compound once it is approved in the United States or Europe. The originator's application may or may not be the first application SFDA receives. SFDA has interpreted the data protection provision of the Drug Registration Regulation to apply after marketing authorization is granted in China. Marketing authorization can take up to four years. During this period additional applications from Chinese companies can be submitted to the SFDA. Any company that receives authorization to begin limited, local clinical trials before marketing approval is granted to the first company is permitted to complete the regulatory process. This can result in multiple companies entering the market with the same product—and no effective data exclusivity for the originator.

In the United States, any non-originator company can seek regulatory approval during the data protection period if it submits a full data package consistent with requirements of a New Drug Application (NDA). China, however, grants marketing approval for products based on incomplete data filings. Applications in the United States during the data exclusivity period must include all elements of the NDA. An abbreviated application is not accepted during the data exclusivity period.

For the above mentioned reasons, we encourage China to revise its regulations to close the loopholes that permit the unfair commercial use of clinical data generated at considerable cost and risk by U.S. companies.

Patent Reform

We encourage China to "link" its patent system and the regulatory approval system. Such linkage would ensure that the SFDA does not grant marketing approval to third parties without authorization of the patent owner if the products are still covered by a patent. Linking the patent system and the regulatory approval system will not only facilitate effective enforcement of pharmaceutical patents, but will avoid the need for infringement actions in these types of cases.

Conclusion

In conclusion let me stress that we are committed to the China market and to Chinese patients. We want to work with the Chinese Government to resolve problems in a collaborative fashion and welcome the U.S. Government's support of these initiatives. I have limited my remarks today to the industry's IP concerns in China. I have not touched on the very substantial market access barriers the industry faces. China is a dynamic and complex market that warrants the attention of this Committee and the Administration. We look forward to working with you to foster a better business environment for American companies operating in China. The U.S. pharmaceutical industry houses some of the best scientific minds in the world and is the global leader in biomedical innovation. With respect to innovation, the goals of this industry are consistent with the goals of this Congress: To quote House Speaker Nancy Pelosi, we share "*a steadfast commitment to being the most competitive and innovative nation in the world.*" China seeks to become a world leader in many innovative industries. Allowing them to steal the intellectual property of U.S. companies only encourages the shift of high paying, high skilled jobs in the pharmaceutical industry from the U.S. to China. We seek your support in upholding intellectual property protection around the globe and here at home to sustain the innovative nature of our industry—and to ensure that new and improved medicines are available in the future.

Chairman LEVIN. Thank you very much.
Mr. Baranay.

**STATEMENT OF PETER BARANAY, CHIEF EXECUTIVE
OFFICER, ABRO INDUSTRIES, INC., SOUTH BEND, INDIANA**

Ms. BARANAY. Good morning, Mr. Chairman and Members of the House Committee on Ways and Means on Trade. Thank you for giving me an opportunity today to testify regarding China's enforcement of IPR. My name is Peter Baranay, and I am President of ABRO Industries of South Bend, Indiana.

I am here representing the Motor & Equipment Manufacturers Association, known as MEMA, and the Brand Protection Council of MEMA, whose purpose is "to provide a forum for manufacturers to discuss counterfeiting, IPR, grey market or diversion, share best practices, recommend solutions, formulate future seminars, and promote networking."

This group was started about three years ago and has over 50 members. Most of the names you will recognize—Ford, General Motors, Dana, Delphi, Tenneco, to name a few. You may be wondering why I am here today instead of one of those big name companies. The answer is simple. Many companies do not want to talk publicly about their counterfeiting problems, and specifically with respect to China and its booming automotive industry. These companies are concerned the publicity will have a negative impact on their customers.

As a member of the President's Advisory Committee on Trade Policy and Negotiation, I know this failure to disclose counterfeit issues facing American companies was a problem when the USTR office tried to build an out-of-cycle WTO complaint against China.

I am pleased to be here with you today to share with you some details of the types of counterfeit problems and issues ABRO and other members of MEMA are facing.

ABRO traces its corporate roots back to 1939, when our founder started as a translation service. By 1944, he had incorporated and was working with manufacturers in the United States selling their products in the international marketplace. By the mid-seventies, the ABRO brand was developed as part of a long-term strategy to continue to sell U.S.-manufactured products overseas.

ABRO is perhaps unique in that 100 percent of our business activity is conducted overseas. Although we do business in over 165 countries, not one dollar of ABRO products is sold in the United States. We began to trademark the ABRO name beginning in the United States, followed by Singapore, in 1980. Twenty-seven years later, the ABRO trademark is registered in 167 countries, and we own nearly 1100 registrations in numerous international classifications.

ABRO considers intellectual property protection of paramount importance. Although we can point to many examples of counterfeiters throughout the world, the one company who was the most egregious and a dangerous economic terrorist with respect to intellectual property is Hunan Magic of China. Beginning as early as 2001, on the heels of the WTO, Hunan Magic not only began to counterfeit ABRO products, but began to represent themselves as ABRO Industries itself, a brazen example of corporate identity theft.

Hunan Magic manufactures in China and exports throughout the world, markets that ABRO Industries developed. This story was

the subject of a page 1 article in the Wall Street Journal in November 2004.

The last 5 years have been enormously frustrating in that in spite of ABRO holding numerous valid Chinese registrations and Hunan Magic holding none, they have operated with relative impunity in their local community and have shipped tens of millions of dollars of counterfeit ABRO products around the world and have destroyed many American jobs.

Fortunately, with aggressive legal action and the support of the USTR office and the U.S. Patent & Trademark Office, ABRO has initiated numerous legal actions and we have prevailed against Hunan Magic on a number of fronts. We have succeeded in stopping Hunan Magic from registering the ABRO mark, although Hunan Magic continues to claim their application as a legal basis for continuing to counterfeit. Hunan Magic has gone so far as to claim that they independently created the ABRO mark and our packaging, a claim that is rather far-fetched as the photograph on one of our often-counterfeited products is the wife of our corporate vice president. She has become rather famous throughout the world.

ABRO has received fair hearings in China at the Trademark Office, and on the Federal level we are prevailing in China. We have conducted a series of raids against Hunan Magic's manufacturing operations, during which ABRO's counterfeit products were seized. We aggressively pursued Hunan Magic within China's legal system, and the case was ultimately decided in our favor in December of 2006 with damages of \$64,000 awarded to ABRO, a small fraction, of course, but a start.

Again, at the Federal level, ABRO registered the ABRO mark with Chinese customs, and a significant number of export containers from Hunan Magic and others have been seized, with the goods ultimately destroyed and fines levied against the exporters and Hunan Magic. We have been extremely satisfied with the cooperation we received from Chinese customs.

Regrettably, business is ultimately local in nature, and Hunan Magic operates openly within Hunan Province as they employ individuals and pay taxes.

Many American companies have found themselves victimized in China and other than countries because they failed to adequately protect their intellectual property. Other companies, such as ABRO Industries, have been proactive but still find ourselves the victims of counterfeiters, some of whom are just as audacious and tenacious as Hunan Magic.

I believe that senior members of the Chinese government fully recognize the need to be compliant with respect to intellectual property, but in many respects actions have not followed their words.

Thank you for giving me the opportunity to testify today, and I look forward to any questions you may have.

[The prepared statement of Mr. Baranay follows:]

**Statement of Peter Baranay, Chief Executive Officer,
ABRO Industries, Inc., South Bend, Indiana**

Good morning Chairman Levin and members of the House Ways and Means Subcommittee on Trade.

Thank you for giving me an opportunity to testify today regarding China's enforcement of Intellectual Property Rights.

My name is Peter F. Baranay and I am President of ABRO Industries, Inc. in South Bend, Indiana. I am here representing the Motor Equipment Manufacturer's Association known as MEMA and the Brand Protection Council of MEMA whose purpose is to "provide a forum for manufacturers to discuss counterfeiting, intellectual property rights, gray market or diversion, share best practices, recommend solutions, formulate future seminars and promote networking."

This group was started nearly three years ago and has over 50 members. Most of the names you will recognize: Ford, General Motors, Dana, Delphi, and Tenneco to name a few.

You may be wondering why I am here instead of one big name company. The answer is simple. Many companies do not want to talk publicly about their counterfeiting problem and specifically with respect to China and its booming automotive industry. These companies are concerned the publicity will have a negative impact on their customers. As a member of the President's Advisory Committee on Trade Policy and Negotiation (ACTPN), I know this failure to disclose counterfeit issues facing American companies was a problem when the U.S. Trade Representative's Office tried to build an out-of cycle WTO complaint against China.

I am pleased to be here today to share with you some details of the types of counterfeit problems and issues ABRO and other members of MEMA are facing.

ABRO Industries traces its corporate roots back to 1939 when our founder started a translation service. In 1944 he had incorporated and was working with manufacturers in the United States selling their products in the international market place. In the mid 1970's, the "ABRO" brand was developed as part of a long term strategy to continue to sell U.S. manufactured products into the International market place.

ABRO is perhaps unique in that 100% of our business activity is conducted overseas. Although we do business in over 165 countries, not one dollar of ABRO products are sold in the United States. We began to trademark the ABRO name beginning in the U.S. followed by Singapore in 1980. 27 years later the ABRO trademark is registered in 167 countries and we own 1,085 registrations in numerous international classifications. ABRO considers Intellectual Property Protection of paramount importance. Although we can point to many examples of counterfeiters, the one specific company who is the most egregious and a dangerous economic terrorist with respect to Intellectual Property is Hunan Magic of China. Beginning as early as 2001, Hunan Magic Power Inc. Company Ltd. not only began to counterfeit ABRO products, but began to represent themselves as ABRO itself. A brazen example of Corporate identity theft.

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Intellectual Property Piracy in China

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We have been extremely satisfied with the cooperation we received from China customs.

Regrettably, business is ultimately local in nature and Hunan Magic operates openly within Hunan Province as they employ individuals and pay taxes.

Many American companies have found themselves victimized in China and other countries because they failed to adequately protect their intellectual property. Other companies such as ABRO Industries, Inc. have been pro-active, but still find themselves the victims of counterfeit some of whom are just as audacious and tenacious as Hunan Magic.

I believe that senior members of the Chinese Government fully recognize the need to be compliant with respect to Intellectual Property, but in many respects actions have not followed their words.

Thank you for giving me the opportunity to testify today and I look forward to any questions you may have.

Chairman LEVIN. Thank you very much.

The Olympics are in Beijing in 2008. I would hope that we would set as a goal some major compliance by China by the year of the Olympics. That is going to be a test not only for China, but also for the United States. It is going to be a challenge and a test whether those who are supposed to be enforcing our laws take the steps necessary that there be a dramatic change in China by next year.

If that doesn't happen, people who go to the Olympics will find the same as in my last trip to China. I left the hotel to just walk around, and I met somebody with a DVD, one dollar. He felt really chagrined that I did not buy the good for one dollar. It was a total counterfeit, of course. So, I do hope that we will set this as an objective.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman. Again, I want to thank you for this very important hearing on an incredibly important hearing.

Mr. Glickman, it is good to see you. As you mentioned, both of us knew each other in our youth in a different life on the House Agriculture Committee.

Mr. GLICKMAN, but you still have your hair, Mr. Herger. I don't.

Mr. HERGER. Anyway, it is good to have you in your new capacity appearing before us. At this point, I would like to direct my question to you, if I could.

At this point, I believe that everyone on this Committee certainly acknowledges that China is not abiding by its WTO obligations on IPR protections, but it would appear that there have been some simplistic criticisms of the USTR for not instantly filing such a case.

Could you tell us, Mr. Glickman, have you supported USTR'S efforts to handle this matter initially through negotiation with the Chinese officials, although those efforts may not bear fruit ultimately? Or was USTR mistaken to negotiate with the Chinese over these problems?

Mr. GLICKMAN. Well, first of all, we have been working closely with Susan Schwab and USTR. We know they are talking to the Chinese government in a variety of venues and number of the problems. We support their efforts. If the discussions do not prove fruitful within a reasonably short period of time, we will support their efforts in litigation. We have told them that.

So, we would prefer that it be resolved through negotiation, but if it is not, then it is time to fight with a WTO case. We have been

working quite closely with Susan Schwab and her team. So, that would be my answer to you.

Mr. HERGER. Good. I appreciate that.

Could you also describe the many efforts that you and your members have made to develop facts and evidence to use by the USTR in any potential WTO case in the future?

Mr. GLICKMAN. Yes. We have spent a great deal of resources in China and in the United States to determine the levels of criminal activity, the thresholds of criminal activity, to develop the factual basis by which a case can be brought, both in terms of enforcement on piracy as well as market acts as issues, not only working with ourselves but with our colleagues up here as well.

This is a potentially incredibly lucrative market, but it is the most extraordinarily frustrating market in the world to get into. China is now in the WTO. I had some role in that because in the Clinton Administration, I was actively involved in the whole debate on PNTR.

So now that they are in this rules-based organization, they have an obligation to follow it. If we don't, we are going to have to litigate it.

Mr. HERGER. Absolutely. I would like comments from any of the other panelists in this same area.

Ms. SCHROEDER. Well, I would totally concur with what Danny says. We are working with USTR. We have been very pleased that they have been working so hard. I think all of us want to make sure that these negotiations aren't just more stalling or humoring us. We have all been humored by the Chinese government over and over again, as you pointed out and I pointed and others. They promise they are going to fix it, but the fix is for like maybe 3 hours or 24 hours, and then everything is back to normal.

So, we really want to make sure this is really serious. I think everybody is prepared to take action if we can't get somewhere and get something that is real.

Mr. HERGER. Good. I think that point is so well taken. I am sure the Chinese are listening.

Ms. SCHROEDER. I hope so.

Mr. HERGER. That we have been trying to work with them.

Ms. SCHROEDER. That is right.

Mr. HERGER. We prefer working with them first, but we are preparing the case. They are in the WTO. We do have a format now that we can move forward on. That is exactly what I believe, on a bipartisan—this is not a Republican/Democratic issue—that we as the United States are going to do.

Ms. SCHROEDER. You are so right.

Mr. GLICKMAN. Can I just reinforce what Mr. Levin said about the Olympics? They are going to have a billion people, maybe more, watching this on TV. They are going to have millions of people going there. They have an opportunity to show the world they want to play by the rules, or they have the opportunity to show the world that they want to be an outlaw.

They protect their Olympic logo very, very visibly and very aggressively because it is important to them. We have got the Olympics coming there, and we have got to make it important to them that they play by the rules.

Mr. HERGER. Absolutely. My time is about up, but anyone—Ms. Ritter?

Chairman LEVIN. You have about 10 seconds.

Mr. HERGER. Ten seconds? Five seconds?

Ms. RITTER. Particularly for the complex issues in our area that straddle intellectual property and the drug regulatory regime, we appreciate the efforts that have been made by USTR and the Commerce Department to try to work out, through collaborating and negotiating with China, a better resolution here.

Chairman LEVIN. All right. Let me just say—and Mr. Blumenauer is next, someone who is involved with China PNTR a bit, to understate it. It has been over five years. It is a long time of noncompliance and of inaction.

Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman. I appreciate your punctuating that point. There are a number of us who spent a lot of time and energy in lesser roles here in Congress working on PNTR, with the expectation—making the argument that in fact this would give us leverage to protect the abuses that we had seen in this country. I share your frustration.

Mr. Baranay, I remember the article in the Wall Street Journal. It paralleled pretty graphically something that we had in Oregon, where a little company was hijacked lock, stock, and website and replicated in China. It is extraordinarily frustrating. I admire your tenacity and the success, apparently, that you are having in starting to move this forward.

I guess I am curious about the push-backs that we have got. In each case, there are some examples you have described of working with the Chinese government. Mr. Glickman, you mentioned that Chinese intellectual property is abused, and again, this was part of the rationale we had with the development of these Chinese industries that relied upon protection of intellectual property, that there may be some leverage that we get over time. Chinese consumers are at risk because of a lack of protection. It tends to be self-reinforcing.

I am curious if any of you have an idea of ways that we have got leverage with the Chinese themselves to sort of harness the forces that you are talking about, that we can in some fashion use to sort of push and reinforce that effort. I love, Dan, your example of the Olympic logo, that they are zealous in their protection. Are there other areas, in academic exchange, for example, where we have leverage or that there are some of these collaborative areas in the industries that you represent that we could be more aggressive?

Ms. SCHROEDER. I think you point out something very important. For Democrats who are free traders, as I am and you are, this is a very difficult thing because we all thought they were going to play by the rules, and they didn't.

When you look at where we have some pressure points, I think the main pressure point is when we can point out that they could do something if they wished to. At every Chinese university, for example, the government knows what is going on. If they are pirating books at the university and putting the university's seal on them, the government could stop that. They can stop the pirated stuff

being sold on the street. They are selling these books on the street right under the nose of officials.

Mr. BLUMENAUER. Right.

Ms. SCHROEDER. If they can shut the store down for 24 hours until Danny leaves town, they can shut it down for good. Same with the drug thing.

Mr. BLUMENAUER. Yes. Let me—

Ms. SCHROEDER. They can do these things.

Mr. BLUMENAUER. Let me be a little more specific. Using the example of the university, we are involved, a number of us are involved, with university exchanges. They are things that the Chinese care deeply about. Is there a way that we can or should be more aggressive in terms of, before these exchanges are considered, that there is some sort of threshold understanding, or that we work this into the discussion on some of these agreements?

Ms. SCHROEDER. Well, we would love it if you would find out that if they are pirating books at the university copy center or that they are downloading electronic journals, like the New England Medical Journal or whatever. That would certainly be one pressure point you could put on with universities.

Mr. GLICKMAN. I might say that this is one area I think that Secretary Gutierrez has been particularly effective in articulating this every time he is over there. At whatever levels he meets, he talks about this, the need, for example, to improve enforcement of intellectual property, the need to work in the Chinese legal and judicial system.

We ourselves have done a lot of training sessions for Chinese jurists and lawyers, copyright officials, because it true that they have a much more limited legal system than we do. We are trying to help them bring that up to date.

One other thing I would point out is that there is a rapidly growing Chinese indigenous film and music industry. Those people are being affected very much as we are. We are beginning to see them speak out because the creative rights are being trampled.

Mr. BLUMENAUER. Mr. Chairman, I know my time is about expired, but this is an area that I would hope that we might be able to explore. I look in my State, where we have got Nike with some interesting interrelationships. We have technology; we have the largest Intel facility in the world, and there are some partnerships there, and the academic exchanges.

Maybe there are ways that we could help refine ways with some of these relationships, that we can find more constructive ways to put in ground floor understandings that might give us some traction.

Chairman LEVIN. All right. We will do that. There are also the abilities to file complaints with the WTO, which tends to turn talk into action.

All right. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. Good morning to our panel. Mr. Glickman, I never had the privilege of serving with you in the House, but I had the opportunity to work with you while you were in President Clinton's cabinet. You and I share a common interest in tall grass prairies in our responsive States. I enjoyed our conversations on those particular concerns.

In your testimony, Mr. Glickman, you make the comment that while fake DVDs litter Beijing, fake Olympic logo materials are impossible to find. So, you are saying that the Chinese government is capable of enforcing IPR laws. Is that true?

Mr. GLICKMAN. Absolutely. Even with the decentralization of the Chinese economy—I am not telling you everything comes out of Beijing because it doesn't. It is a complicated society, and there are multiple power centers throughout this country.

If they were to choose to fight this problem, they would do it. In fact, we have seen it. In the area of DVDs, before major events, film festivals, you will find the streets of China empty of fake creative product from the movie industry, film, television, or even music. Then it reappears again. So, they can do it.

In discussions with Chinese local officials like Mayors of cities, they talk about the fact that they recognize that it can be done. In fact, on a couple of occasions, they have mentioned the Olympics again as a hook, that they hope that their country—

Mr. WELLER. Are you suggesting then that their enforcement is selective?

Mr. GLICKMAN. It is selective. It is arbitrary. It is intentionally vague in some cases. In some cases, it is just not very well developed.

Mr. WELLER. You mentioned earlier in your opening comments that there were 50 facilities that manufacture pirated DVDs. Do you know the locations and addresses of these facilities?

Mr. GLICKMAN. In most cases we do. In most cases we have given that information to the authorities. In some cases they have taken action, and in most cases they haven't taken it as aggressively as we would like. Some of these are run decentralized fashion. Some of them are run by remnants of the old People's Liberation Army. It is a complicated way to get at.

Mr. WELLER. So, when it comes to enforcement, do they only enforce when they are reminded that they need to? Or do you see any proactive efforts other than Olympic logos that they are proactive?

Mr. GLICKMAN. There has been, as Pat said—and I don't know about in the pharmaceutical area—but there has been some, I would say, less than full effort over the last year or so to engage in enforcement actions, but I would have to tell you they are not satisfactory.

Mr. WELLER. Mr. Baranay, you shared your experience with going through the litigation process to address, and you were successful. \$64,000 doesn't seem like a lot of money from the standpoint of an award, considering probably the impact of lost business.

Do you believe that there is an unspoken acceptance of intellectual property right violation by the Chinese government, that they accept it unless they are reminded that they need to do something about it as part of their agreements?

Ms. BARANAY. I think it is clear that as the Chinese economy develops from, shall we say, the world's manufacturing floor or the world's factory floor to an economy where they themselves have intellectual property worthy of protection—I would challenge most people to identify two or three Chinese branded companies. People hesitate. It is very difficult.

Most Chinese products come into this country as private label products of other manufacturers. As such, the Chinese don't have a great incentive at the local level to protect intellectual property. I see that changing with manufacturers, particularly in the automotive industry developing their own brand, or the appliance industry developing their own brands, or in our case the automotive industry, automotive chemicals.

Yes, I think the selection—the enforcement is selective, depending on the circumstances and depending on the pressure that is brought to bear. I would say, though, that from a systematic standpoint, when we have gone up against the Chinese in the Chinese system, we have been treated fairly.

So, in that case, the laws seem to be in place and they seem to be enforced, but we are an exception. We just maybe a little more tenacious than others.

Chairman LEVIN. Ms. Ritter, do you agree?

Ms. RITTER. Well, I am—

Chairman LEVIN. You have got 20 seconds this time.

Ms. RITTER. I do agree that we have been able to get some collaboration from the Chinese authorities. As I mentioned in my testimony, raids and seizures are higher than they have ever been, but you see a real falloff in whether cases make it all the way through the system, and you don't see a lot of criminal sanctions, especially at deterrent levels, actually getting imposed at the end of the process.

So, I think the Chinese recognize the safety consequences of counterfeit drugs, but there is a lot more to be done.

Mr. WELLER. Thank you.

Chairman LEVIN. Okay. Thank you, Mr. Weller.

Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman. Good morning, panel.

Ms. Ritter, China is seeking to build its own domestic pharmaceutical industry. It already has manufacturing the chemical capacity, as well as the workforce. Due to poor intellectual property protection laws—we are talking about that this morning—in many areas, and obviously due to the lack of enforcement, much of the costly development of funding is not required for that.

I don't know who is following the rules and what the rules are and why they are even made. This is important, I think, from a safety standpoint, and a worldwide threat, as many of these drugs are exported, as you know. I don't want to get into too much of that aspect of where those drugs are going, but that is fascinating to look at that stream.

Second, from a trade perspective, it hurts the American economy. It hurts New Jersey, and I have been there all my life, so I am concerned about that. We employ about 62,000 people in New Jersey in the pharmaceutical industries, good paying jobs.

The average job, Mr. Chairman, in New Jersey in the pharmaceutical industry is \$116,000. We don't want to lose those jobs. They are very important, very significant. That adds about \$7 billion to New Jersey's economy, wages and salaries.

The industry pays over \$750 million in taxes in New Jersey. So, a loss of these jobs and a loss of the industry is going to be dev-

astating, no less devastating than what we did to the textile industry in New Jersey and a lot of other places, but that horse is out of the barn, isn't it?

My question to you is this. The Chinese market is vital. A mutual cooperation is therefore essential. Is this the wave of the future if nothing is done about intellectual property protection? Is that what we can expect 10, 15, 20 years from now? What do you think?

Ms. RITTER. I think you have said it extremely well. We are at a critical time in China. China does want to develop this industry. They have got the science base to do it, to develop a vibrant domestic industry.

For that industry to be legitimate and produce quality products, they are going to have to address the counterfeiting situation and the protection of intellectual property. Right now, you have got a very dangerous situation, where we are facing massive competition in that market from a host of unregulated, unsafe suppliers.

Our estimates are that it is costing the industry several billion dollars every year as a result of the lack of protection in China. Just as you said, we employ hundreds of thousands of people in the U.S., very good high tech jobs, very good salaries, and there is absolutely a direct impact there.

Mr. PASCRELL. Yes. Those jobs are significant, no more significant than the person who works in a textile factory or in a small parts factory that, on the average, would be making between 45,000 and 65,000. So, one job is not more important than the other to me. I can only speak for myself.

Mr. Chairman, this is like how we built railroads in the United States. We didn't allow every town to veto. We would never have any railroads. So, we passed Federal legislation dealing with communication. I don't expect every congressman is going to be able to put his two cents in to whether or not a trade bill makes sense or does not make sense.

I would think under Article I, section 8, that we should have some input and not be willing to fast track our own responsibilities, our own responsibilities, in putting a decent, mutually respectful bill together. I am pro-trade. I am not free trade, but we should be able to come to some agreements on this and insist that the other party follow the law.

If we don't do that, then is there teeth in the law? Is there teeth enough in the law? Are we sincere enough to follow up our own part, or we don't want to make any enemies? We don't want to make anybody in the Chinese government angry at what we are doing? I am not interested in making people angry. I want a mutual agreement that is respectful of all of our responsibilities. I thank you for your testimony.

Chairman LEVIN. Thank you.

Mr. Brady.

Mr. BRADY. Thank you, Mr. Chairman. Thanks to the panel. These aren't new issues, but you have made very compelling arguments why we need to turn the volume up on the enforcement side of it.

Two questions, one dealing with WTO, another with Trade Promotion Authority (TPA). We hear around here even today that al-

lowing China Most Favored Nation status in accession to WTO was a huge mistake, that our problems with China began on that day and our participation and engagement is causing us problems because of our involvement in WTO.

I see it a bit differently than that, looking at the enforcement mechanisms that have been used, are available as the best way to level the playingfield. Do any of you believe that America's allowing China to enter WTO was the wrong thing to do?

Mr. GLICKMAN. I do not think it was the wrong thing to do. I, as I said before, was somewhat involved in this when it happened.

Mr. BRADY. Absolutely.

Mr. GLICKMAN. I was involved with a different industry then, where I think the benefits were more clear than they are in other industries, but I would rather have them in the tent and subject to the laws and go after them—because, let me tell you, the problems far preexisted the WTO accession, and the imbalance of trade far predated that. We just now have to use that law and use those rules to protect ourselves.

Mr. BRADY. Those tools are the ones that got us progress in the advance to micro systems, computer boards, and in the fiber board issues already. Your point is be more aggressive using those tools to combat piracy in all those areas.

Let me ask another question. Trade promotion authorities will expire July 1st of this year. You are all in industries that have major markets overseas, have a big impact on whether we are out there leveling the field for you to sell your books and your pharmaceuticals and your movies and your air conditioners.

In your belief, would it be wise for Congress to allow TPA to expire July 1st? Does that level the playing field for your industries?

Ms. SCHROEDER. I think that is a hard one. You ask a very difficult question. I have always been a free trade Democrat, which is a little lonely on my side of the aisle. I have always voted for fast track when I was here. I think one of the problems right now is the voters want us to have to be a little more aggressive in making sure agreements are honored by both sides.

I think China came into WTO, and it is great to have them in the tent. China thinks, because they are so big, they can do what they want. We will bend the rules our way rather than the way the universal group has interpreted them.

So I think some hesitation you would find on this side, that we would like to be in there, but under WTO accession, for example, they were supposed to allow book publishers to be able to be in the market. We have never been allowed in the market, and it is now over 5 years later. So, those are the things that make us hesitate a bit to advocate extending TPA.

Mr. BRADY. So, being out of the trade field while other countries developed trade agreements that favored books from other countries or products from other countries, that doesn't harm your members at all?

Ms. SCHROEDER. It harms our members and we want to be in there, but when we had a WTO accession that would have been helpful to us and it still hasn't been implemented, then you get a little worried. Basically our group has been very much for free trade and for fast track. That is why they are working so hard with

USTR to try and consolidate gains we were supposed to have gotten under the original WTO accession.

Mr. GLICKMAN. It is like—I think generically, I think that the President needs fast track authority. I think the problem is that the old—Reagan used to use this line, trust but verify. The fact of the matter is, there is this feeling that the Congress is not getting its position felt in areas like the environment and labor issues where the executive branch may be moving the thing along without any restrictions whatsoever.

I think, generally speaking, an executive needs that kind of authority, but it is up to you to figure out a way to protect your constituents on some of these changes where folks are getting hurt as part of the process toward globalization.

Mr. BRADY. Well, I think right now we are looking at trying to find common ground on workers rights, environmental rights, trade adjustment, because there are jobs lost and you have got to address issues like—and enforcement, which is the panel here.

Any other thoughts before the Chairman—he is less likely to gavel you down than me.

Chairman LEVIN. I think I will because we want to try to stick to our time limits. Let's have some further discussions about China PNTR and the involvement of a number of us who are still in the Congress. We should do that.

All right. Let me go over the list, and I think my pal from New York is next. Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman. Thank you for your presence today and your discussion.

I have a number of constituents who have come to my office complaining about their copyright, their IP issues within China itself, dual nationals or individuals who are American citizens today, but born in China.

Mr. Baranay, I am not in the position today to discuss those particular issues, as tempted as I am to want to talk about them more openly, because I have—I believe in the carrot and the stick approach. I am still using this carrot approach with the Chinese government. I want to continue to do that, and work with them to try to see if we can work through some of these issues.

I also have been involved in the inter-parliamentary exchange between the United States and China. I vice Chaired that exchange in the last few Congresses and hope to in as the Chair or co-Chair within this Congress, and look forward to traveling once again to China.

I can tell you all that amongst the issues that we have talked about, human rights has certainly been up there at the top of the agenda, but then IP, IPR, has become a top two or three issue or category of issues that we have been talking about when we do go. So, I can tell you that in terms of Members of Congress and our interaction with parliamentarians, with government officials, I can tell you that whenever I have been in a meeting with Chinese government officials here in the States, the issue of IPR has been raised continuously.

I would, though, like to get a sense from you—and then, Mr. Glickman, you may be able to, and Ms. Schroeder as well, and Ms. Ritter, in terms of your umbrella groups, more or less. You can

speak a little bit more broadly because you are not in any respects speaking for one company's point of view, but talking in a broader sense—of what your relationship is.

Is there a counterpart? Do you have a counterpart in China? What is your relationship with that counterpart, if it exists, or is it developing? What are they doing in terms of, from their side of the world, addressing the issue within the Chinese government?

Then I would also like to know what you believe in terms of what is happening with USTR. I know that USTR and the ambassador has a tremendous amount on her plate, but what more can they be doing to help open up some of the markets that you are talking about?

I know, Mr. Glickman, you have talked specifically about the limitation on films and distribution and access to markets in China; and Ms. Schroeder, I know the same thing for you, and maybe historically, a more difficult subject is text; and pharmaceutical, obviously, as well.

Maybe if you can just give me the sense of what is your counterpart, does it exist, and what is the relationship? Two, what are the expectations that we should be asking for from our own trade reps?

Ms. SCHROEDER. We do work very closely with the Chinese Publishers Association, which is amazing. They are very strong. Piracy hurts them equally. They love to stand with us. They are a little hesitant to be too vigorous alone against their government.

So we have worked with them, and I think that has been very helpful. We still need more leverage. I think publishing is unique because the Chinese want to control what people read. That may be why they don't let our people publish internally or import internally, but it has been very interesting. Even though they don't let us come compete with them directly, the local people are still very much for us because their stuff is getting pirated, too.

Ms. RITTER. There is an association of research-based pharmaceutical industries in China. A lot of the members there are subsidiaries of global companies, so we are very well aligned and do coordinate, and they try to work day in and day out with the Chinese government on some of the issues that we have discussed today.

We also work closely with USTR and also the Commerce Department through initiatives like the Joint Commission on Commerce and Trade on some of the issues I have discussed today. We would like to see some of those issues elevated even further—through that process, through the Strategic Economic Dialog process that Treasury has led—to really make sure that all of the various organs of the Chinese government that relate to our problem are engaged and working toward finding a solution.

Mr. CROWLEY. Mr. Chairman, can Mr. Glickman—

Chairman LEVIN. Yes, please.

Mr. GLICKMAN. I would just say a lot of the management of the Chinese film industry is government, but a lot of the creative side we work with quite closely because they are becoming more outspoken in their concerns about this issue.

Second, in the Chinese system you have Beijing and you have the regions. So, one of the more difficult things is figuring out who is in charge, who is making decisions here, and where is it coming

from. That is something that we are doing in terms of helping USTR as they look at the possibility of filing a WTO action.

I do think that the biggest thing that can be done right now is for the Chinese industry and government to see our Government committed to taking legal action if it thinks that it has got a case that can be brought legitimately.

Chairman LEVIN. Thank you.

There are two, maybe three of us left. So, let's see if we can work ourselves in. That means we will start the second panel a bit late. Mr. Meek? I think you are next. Then Mr. Kind, and then Mr. Reynolds if he is able to return.

Mr. Kind. We are glad you could join us.

Mr. KIND. Well, thank you, Mr. Chairman. I want to thank you for holding this very important hearing. I want to thank the witnesses for testifying and giving us your perspective on an immensely huge and important issue.

I think, Mr. Glickman, you are exactly right, that whenever any of us in Government have the opportunity to go and travel to China, whether it is Executive Branch officials or Members of Congress, that we continuously raise this issue with the Chinese officials and authorities so that they understand where we are coming from in regards to the IPR issue.

I had the opportunity about a year and a half ago to do just that with a delegation, meetings in Beijing and Shanghai. It is complicated, and one of the things I am hoping you could give us a little insight on here today is the scope of the real challenges that we are facing because obviously, our relationship with China is incredibly important. Outside the Muslim world, it is probably going to be the most important strategic relationship that we have with another country or another region in this century.

Yet you wonder how much leverage we ultimately have over them because I think they sense that we are so desperate to gain market access that they are holding a lot of cards. Let's face it, we have become incredibly dependent upon them to finance our deficits. They are buying up a lot of our bonds today, basically freeing up a lot of capital, keeping rates low for us here. We have been very dependent on them in dealing with the North Korean situation, too.

Yet what I am wondering is, looking at their laws, it seems the laws are good on the books and the penalties are sufficient. So, the question is, is this really a matter of will on their part, not willing to do it? Or is it a matter of capacity-building, that they need more help in order to develop the infrastructure of enforcement? They have a lot of other economic crimes, too, that they are worried about.

In talking to one official—I think it was the Mayor of Shanghai—he said, you are going to see an improved effort for enforcement once the Chinese start having more skin in the game, and that is, starting to develop their own products that they want IPR protection over. We are seeing that now with their Olympic label and how tough and stringent they have gotten enforcing the protection of their Olympic label.

Yet talking to another governmental official in Beijing, he says, the problem is even bigger than any of that. It is really cultural,

based on Confucius' philosophy where if you adopt someone else's ideas, whether it is a movie or music or written material or some product, it is a form of a compliment and not viewed as economic or intellectual theft in their culture.

So, I guess from your perspective, what is the scope here, and where can we be most effective in encouraging them to do the right thing as far as IPR protection? Do we need to be thinking as far as more assistance with capacity-building and helping them do a better job of enforcement?

I guess I will leave it open to anyone who has any thoughts on this subject.

Ms. SCHROEDER. Let me just say with education you are absolutely right. It is a very difficult thing to get any government to try and deal with educational materials. They want to take everything we have created in higher ed, and they want to take it and get it into the brains of their people, and then they come to compete against us.

You can understand. They say, well, it is out there, and I guess it is a Confucian thing. You ought to be willing to give this to us.

Mr. KIND. Right.

Ms. SCHROEDER. The problem is, those are very expensive materials to create, very, very. When they pirate it all, what can you do? Stopping campus piracy is a much less complex issue than many of the other IP issues because the universities really are under the control of the Chinese government.

Danny Glickman is absolutely correct that one of the Confucian things about trying to deal with all of these issues, the trade book issues and probably the pharmaceuticals and everything, is the regions are different, and who is in charge? It gets to be very, very confusing.

Universities aren't confusing, it is a very clear-cut area. We really need more work, too, on what is going on with the websites and the digitization of everything.

Mr. KIND. Right.

Ms. SCHROEDER. Allowing the world to download everything free would kill all of us. You are seeing movies digitized, too, aren't you? The Chinese are saying now they are going to focus on it, but the question is, what does that mean, and are they going to do anything about it? That is our frustration.

Mr. GLICKMAN. I think it was John Maynard Keynes who once said, "For every complicated problem, there is a simple and a wrong solution." This is the classic example. This is a very complicated problem. So, you have mentioned capacity-building. It has got to be a big part of it. We have got to train these people to understand the significance of a legal system in a modern world with instant communication.

You also have to have an enforcement component of this as well. We have got to make sure that we get the Internet and powers of communication so that the restrictions and the censorship there don't keep these people insulated from what is happening in the rest of the world.

Going back to I think it was Mr. Weller's question—I am not sure—about the WTO, the fact that they are in the organization gives us some leverage, not a lot, but some, that we didn't have be-

fore, but we have to remember that it is a massive, complicated problem.

Mr. KIND. Thank you, Mr. Chairman.

Chairman LEVIN. Mr. Meek.

Mr. MEEK. Thank you, Mr. Chairman. I am excited by the fact that we are having this hearing here today because this is so very, very important.

As some of you know on the panel, I represent the State of Florida, and I am the only Member on the Committee on Ways and Means from Florida. We have a lot of companies in South Florida and in Central Florida very excited about trade, very excited about being the closest port to Africa and also to Latin America. We have a number of headquarters there. Sony has a big presence, I think, and their Latin music department. Also Perry Ellis. A number of these companies.

They are talking to me more about China. They are talking to me about the fact that we haven't leaded up enough to be able to deal with China. I believe that we are running into a situation, Mr. Chairman, where we are concerned about the guns and the missiles and the people that we are at war with at this particular time, and we are not concerned about the economic issues that are happening right under our noses. U.S. companies are being cut at the knees because of the lack of IPR in China.

Now, I have never been to China, but I can tell you from what I have read and what I know at this point from U.S. companies that are having problems as it relates to protecting the hard work and the research, since we have our pharmaceutical representative here, we are going to find ourselves in deep water.

I am very interested in hearing from the panel if you have the opportunity to enforce, need it be through our international organizations or even as a Member of Congress. What are some of the things that we should lean forward on and letting our voice be heard? What are some of the things that we can do to try to get China to do the right thing?

I believe it is the good cop/bad cop scenario. Of course they are going to protect their own interests, but when it comes down to—if you even look at the issue of steel, what they have been doing with steel and hurting the market here, hurting our suppliers here, because they have been able to use it as a national security issue and manufacture steel.

Even in some of the areas of—I have Bacardi in my district. I have Perry Ellis in my district. They are feeling the effects of this. It is like no one—where is the police? No one can enforce this. It is hurting their business.

So, I would love to hear, in the time that is left, from any of you on the panel: What are some of the things, if you had the opportunity to be in Congress at this time—I know some of you have—but what kind of forward lean would you have to make this hearing fruitful as we start to step off in this new endeavor of not only enforcement but education with China?

Mr. GLICKMAN. One, Congressman, I would make sure that there are resources for USTR, for Customs, for the enforcement at the borders. It strikes me that we have not probably dollared up the necessary resources to help find the problem where it is taking

place. I think those folks need that very, very desperately. So, that would be one specific suggestion.

Ms. SCHROEDER. I would also say that when you meet with the Chinese, ask them to do enforcement that passes the straight face test. We got all excited when they raided universities, but if you raid universities when they are out of session, you are not going to find a lot, and so they also didn't find very much.

So, the thing is, look. You have got the resources to do it. Let's do it right and let's not play games with each other. The straight face test, when it comes to enforcement, I think is going to be very important.

Ms. RITTER. Excuse me. I would echo some of these themes, and particularly the one of enforcement. Fake Chinese medicines are a threat not only to Chinese patients, they are a threat to patients around the world, and including in the United States.

There have been some very high-profile cases of drugs, often ordered over the Internet, coming in from China to the United States and threatening our country. So, I think that is a particularly important aspect of this problem we haven't discussed as much today, but shouldn't be overlooked.

I think, again going back to the theme of capacity-building and collaboration with China, particularly in the drug area, the problems really are so complex and there are so many actors involved in this that we have got to develop a broader comprehensive framework there for addressing them. That is going to take very high level attention.

Ms. BARANAY. If I could echo what Chairman Levin said, I think the timing with the Olympics in 2008 is extremely auspicious. I think that the world will be looking to China. There is an opportunity here to put pressure on China that they wouldn't necessarily—the timing is actually very good. They understand IPR. It is just whether or not they are going to let us make them play by the rules.

Mr. MEEK. Thank you, Mr. Chairman.

Chairman LEVIN. Well, thank you. An excellent question, and an excellent panel. You represent four vital sectors—motion picture, publishing, pharmaceuticals, and MEMA. So, we really appreciate your participation. So we bid you farewell. Come back and see us. The next panel will come forth.

[Pause.]

Chairman LEVIN. Let's go. We are bit behind schedule, but I think this is going to work out.

Thank you all for joining us on this truly vital subject. Mr. John Goodish—I will introduce you, if I might, all together, and then you will take over—is the Executive Vice President and Chief Operating Officer of U.S. Steel.

Frank Vargo is the Vice President of International Economic Affairs for the National Association of Manufacturers.

John Bassett, III, is Chairman and CEO of Vaughan-Bassett Furniture Company in Virginia.

James Tyrone. Mr. Tyrone is Senior Vice President of Sales and Marketing for the NewPage Corporation.

Professor Navarro is at the University of California, Irvine. If you came all the way, tell us how you managed. We especially welcome you.

So, each of you, your testimony will be placed in the record. If each of you could try to take just the 5 minutes, that will leave us ample time. We will start in the order mentioned. Mr. Goodish.

STATEMENT OF JOHN H. GOODISH, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, UNITED STATES STEEL, PITTSBURGH, PENNSYLVANIA

Mr. GOODISH. I am happy to testify today about a topic that is crucial not only to the U.S. steel industry but to all American manufacturers. That is the growing concern about the subsidies and State support of industrial capacity in China, and the extreme impact we are seeing on global markets as a result of these policies.

I would like to show you some slides that illustrate the seriousness of the problem that we face. As you can see from this first slide, there is a great deal of evidence that China has the most heavily subsidized steel industry in the world. Let me give you a few examples.

Press reports indicate that in 2000, 37 Chinese steel enterprises took advantage of \$7.5 billion in government-directed financing through the debt to equity swaps. Also in 2000, China's government announced that \$6 billion would be spent to upgrade and transform the steel industry.

In July of 2005, China issued a new steel policy to guide the industry for the next 15 years. This policy calls for continuing subsidization of key steel projects, exports, and technologies. Available evidence suggests that consistent with this policy, significant government resources continue to flow to the Chinese industry. Chinese subsidies take many forms, including preferential tax treatment, subsidized materials and energy, and discount loans.

On this second slide, you can see the result of these massive subsidies. Over the last 10 years, China's steel production has quadrupled, surging from an estimated 100 million metric tons in 1996 to approximately 420 million metric tons in 2006. That is roughly the equivalent of building three entire American steel industries in just one decade. No other country has come close to adding so much new capacity, as shown by China's production as a percentage of global production.

Slide 3 demonstrates that Chinese steel expansion has accelerated in recent years. To understand the enormity of what is taking place, consider that from 2003 to 2006, China's increase in production was about twice the total yearly production of either the United States or Japan.

My fourth slide shows that China's domestic market cannot support all of that new capacity. China's steel trade balance shifted by roughly 50 million metric tons from 2003 to 2006, as China went from a major net importer to a large net exporter.

How are these developments affecting U.S. producers? As you can see from slide 5, Chinese imports are flooding this market. In fact, steel imports from China reached 5 million net tons last year, more than double the 2005 level. Chinese steel increasingly competes with our highest value products, including corrosion-resistant

steel, cold-rolled product, and our oil country tubular goods. Now is the time to address this import surge. We do not want a repeat of what happened in the late nineties, when a flood of unfairly traded imports precipitated a major crisis.

The USTR's recent decision to bring a WTO challenge with respect to nine prohibited Chinese subsidies is a good first step, but the USTR'S actions involve only a limited subset of subsidies and does not in any way address the vast evidence of enormous domestic subsidies that buildup many of China's largest steel enterprises and continue to unfairly benefit Chinese producers today.

There are a number of critical policy actions we can and should take. First, we must strictly enforce our trade laws, which often represent our only practical line of defense against foreign producers whose market-distorting practices would otherwise cause imports to overwhelm this market.

Secondly, we urgently need real China legislation. We should apply our anti-subsidy law to the world's largest subsidizer. We also urgently need real action on currency manipulation, rather than allowing China to continue stringing us along with talk and tiny adjustments.

Finally, we must preserve our anti-dumping and anti-subsidy laws in the face of efforts to weaken them in the context of international negotiations, such as the ongoing go-around and the U.S.-Korean FTA talks.

We hope that you will send the clearest message possible that you will reject any agreement that weakens our anti-dumping or countervailing duty laws. If we act now together, we can stop further unfair Chinese trade, make steel markets more efficient, and prevent another steel crisis. Thank you.

[The prepared statement of Mr. Goodish follows:]

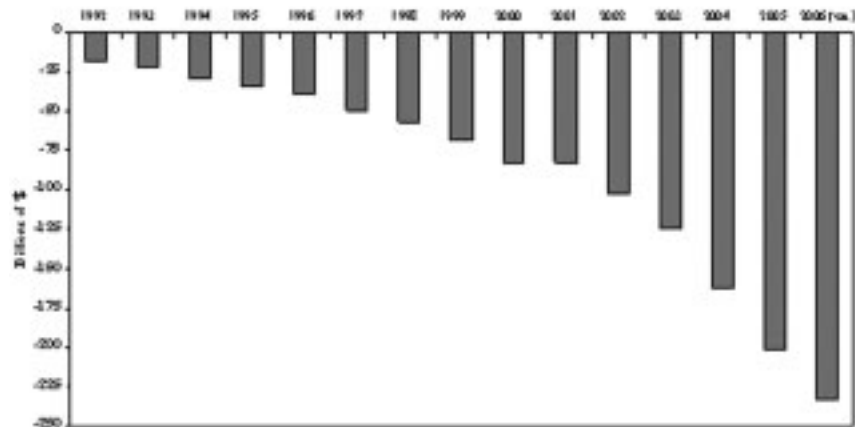
Statement of John H. Goodish, Executive Vice President and Chief Operations Officer, United States Steel, Pittsburgh, Pennsylvania

I am pleased to be here today and to have the opportunity to testify about a topic that is crucial not only to the U.S. steel industry, but to all American manufacturers—that is, the growing concern about subsidies and state support of industrial capacity in China, and the extreme impact we are seeing on global markets as a result of these policies.

Introduction

At the outset and to put this issue in context, it is worth keeping in mind the massive and growing U.S. trade imbalance with China. The U.S. trade deficit with China soared from around \$84 billion in 2000 to over \$225 billion in 2006 (Figure 1). This exploding deficit is having a devastating impact on U.S. manufacturing. Industries like ours are losing core customers in this market, seeing basic industrial capabilities evaporate, and witnessing the loss of whole industries. The China problem with regard to the steel industry is especially grave, but is really just one of the most vivid examples of a crisis impacting American manufacturing generally.

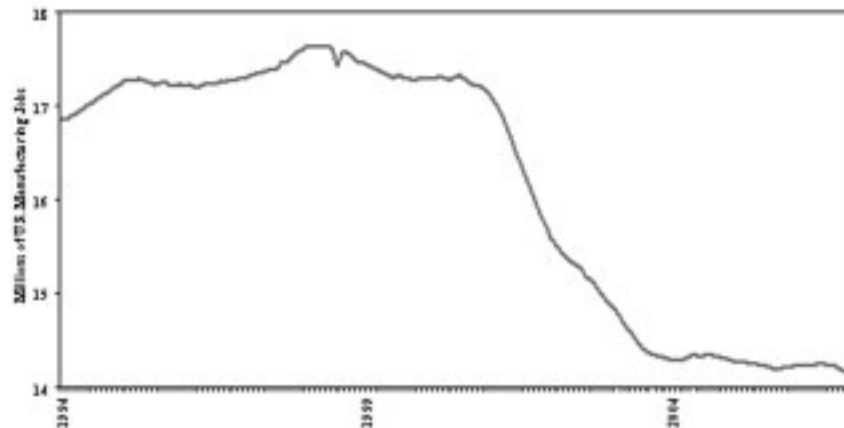
U.S. Trade Balance with China



Source: U.S. Census Bureau, Summary for 2008 based on data from January to December 2008.

The trade imbalance with China and the rest of the world is having especially grave effects on employment here in the United States, as foreign exports—often unfairly traded—are costing American industries both customers and capacity. Since 2000, the year we granted China permanent normal trade relations (“PNTR”), the jobs of over 3 million American workers have disappeared (Figure 2). What’s especially troubling is that these jobs have still not returned, despite consecutive years of apparent economic recovery. This impact is due in no small measure to the export-inducing industrial policies of countries like China, which refuse to play by the rules.

U.S. Manufacturers Have Suffered Massive Job Losses



Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

The steel industry, and indeed U.S. manufacturers generally, should not and do not object to new manufacturing capacity overseas that results from real-world investors putting their hard-earned money into new facilities that are driven by market demand. But that is not what is happening, particularly with regard to China. The invisible hand of the market is not driving China’s exploding exports. Rather,

the Sino-U.S. trade imbalance reflects the hand of Chinese government, and the massive resources it has devoted to assisting its national industries.

As this committee well knows, China uses a wide variety of policy tools to support industry and exports. Among these, deliberate suppression of the Chinese currency's value is one of the most significant. Indeed, in the view of many, currency manipulation represents the biggest single subsidy provided to Chinese producers. From 1994 until July 21, 2005, China pegged its currency ("yuan" or "RMB") to the U.S. dollar at an exchange rate of roughly 8.28 yuan to the dollar.¹ The Chinese central bank maintained this peg by buying as many dollar-denominated assets in exchange for newly-printed yuan as needed to eliminate excess demand for the yuan.² On July 21, 2005, China made a slight modification to this peg, raising the value of its currency by 2.1 percent, tying the value of the yuan to a basket of currencies, and allowing the yuan to fluctuate by 0.3 percent on a daily basis against the basket.³ The effects of this change have been minor; as of this week the dollar was still worth 7.75 yuan.⁴ Given that some experts believe that yuan was undervalued by as much as 40 percent,⁵ it is clear that the yuan is still not trading in line with its true market value. This manipulation is at once a substantial export subsidy and import barrier, making Chinese exports cheaper abroad and increasing the price of U.S. goods in China.

Other examples of Chinese industrial policy and market-distorting behavior could easily be provided. These range from failure to enforce intellectual property rights, to manipulation of raw material markets, to limitations on trading rights, to requirements for technology transfer, to a whole range of other unfair practices, many of which explicitly violate WTO commitments. These market-distorting mechanisms have been well-documented in government filings by the steel industry, and many other industrial sectors.⁶

Clearly, however, one of the most troubling and distortive aspects China's trade regime is the topic of this panel: namely, China's industrial subsidies. These are at once among the most blatantly unfair and illegal aspects of China's policy, and the impact on world markets is becoming more apparent every day. In short, the matter of Chinese subsidies is one of the most crucial issues facing the global steel industry, as well as many other industries, today.

Chinese Subsidies to the Steel Industry

There can be little doubt that, without subsidies past and present, China's steel enterprises would look very different than they do today. In the early 1990s, Chinese steel companies were widely viewed as utilizing low technology equipment and suffering from low productivity. Nonetheless, the Chinese government decided to inject massive funds into these mostly state-owned companies in an attempt to *create* export-oriented steel giants, with little or no regard for principles of global supply and demand. According to published reports and independent experts, very significant subsidies were granted during 1999 and 2000. Just to give a few examples:

- In the late 1990s, the Chinese government reportedly allocated \$7.25 billion (RMB 60 billion) to fund bargain-rate subsidized loans to state-owned steel enterprises for major technology upgrades.⁷ According to this policy, discount loans were targeted to certain "key" technology projects specified by the state's industrial policies. In particular, the government reportedly aimed to encourage production of high value-added steel products, including galvanized sheet, cold-rolled sheet, and oil country tubular goods.⁸

¹Wayne M. Morrison and Marc Labonte, "China's Currency: A Summary of the Economic Issues" (Congressional Research Service Report for Congress) at 1 (March 17, 2006) ("Morrison and Labonte").

²*Id.* To obtain an idea of the magnitude of China's currency manipulation, consider that one expert estimated the value of these asset purchases to be \$15 to \$20 billion *every month*. See U.S.-China Economic and Security Review Commission (hearing transcript) at 103 (Apr. 4, 2006) (testimony of Dr. C. Fred Bergsten, Director, Institute for International Economics) ("USCC Hearing").

³Morrison and Labonte at 2.

⁴See Universal Currency Converter, available at <http://www.xe.com/ucc/> (last visited Feb. 12, 2007).

⁵Congressional Research Service Report for Congress, "China's Currency: Brief Overview of U.S. Options" at 2 (Nov. 29, 2005) (available at <http://fpc.state.gov/documents/organization/57797.pdf>).

⁶See, e.g., Letter from Barry D. Solarz, Vice President of the American Iron and Steel Institute, to Gloria Blue, Executive Secretary of the Trade Policy Staff Committee (Sept. 18, 2006).

⁷OECD, "The Reform of the Chinese Steel Industry" CCNM/NIS/DSTI(99)52 (Oct. 1999).

⁸*Id.* at 7.

- Estimates suggest that at the end of the 1990s, over 50% of China's steel firms were losing money.⁹ According to an OECD report, the Chinese government bailed out several unprofitable state-owned steel enterprises by transferring extensive debts the firms couldn't repay. To accomplish these debt-to-equity swaps, the government established and capitalized four "Bank Asset Management Companies."¹⁰ These companies took on the enterprises' non-performing loans, exchanging them for stakes in the failing producers of dubious real value.¹¹ Indeed, in 2000, the OECD expressed concern that the swaps were nothing more than a "free lunch" for China's largest state-owned enterprises.¹² Estimates suggest that this "free lunch" was enormous. In 2000 alone, 37 Chinese steel enterprises reportedly took advantage of \$7.53 billion in government-directed financing through debt-to-equity swaps.¹³
- Press reports from this period also describe the Chinese government's effort to essentially force many steel enterprises to merge, after which debts of the resulting merged entities held by China's state banks were cancelled. In 2000, for example, reports suggest that the write-off of debts following forced mergers saved China's 100 largest steelmakers an estimated RMB 1.5 to 2 billion (\$181 to \$242 million) in interest payments.¹⁴
- Also in 2000, China's government announced that \$6 billion would be spent over the following few years to upgrade and transform the steel industry.¹⁵

Moreover, these historical subsidies correspond to what is apparently a long-standing official policy of the Chinese government to artificially support the steel industry. China's five-year plans, which address virtually every aspect of the country's economy, have reportedly ordered governments at all levels to support the expansion and technological renovation of the steel industry. China's ninth five-year plan, covering the years 1996 to 2000, openly called for the development of certain key production technologies, including automobile, oil, and other advanced types of steel.¹⁶ The tenth five-year plan, for 2001 to 2005, laid out a very detailed outline to upgrade the entire steel industry.¹⁷ The plan designated "core" regional steel enterprises to be targeted with government support, and even set export goals for each such enterprise.¹⁸ For example, the plan designated Baosteel Corporation, now China's largest steel producer, as the "core" enterprise for China's Eastern region, and set an export goal of 3 million MT per year by 2005 for the producer.¹⁹

This explicit state planning, along with an apparent *policy* to engage in widespread subsidization of the Chinese steel industry, continues in China's most recent steel plan. In fact, in July 2005, China's National Development and Reform Commission adopted a new National Steel Policy to guide the industry's development over the next 15 years.²⁰ Several of the policy's provisions indicate that China continues—and will continue—to artificially support its steel enterprises, placing particular emphasis on producing and exporting high-technology steel products:

- The policy states, "there shall be supported and organized the implementation of localization of steel industry installations so as to improve China's research and development, design and manufacturing ability of key steel industry technological installations. The state will provide tax support, interest subsidization support, scientific research funding support and other policy support to support

⁹"Output controls boosting China's steel industry profit," *Asia Pulse* (Aug. 18, 2000).

¹⁰OECD, "Reforming China's Enterprises" at 78 (2000).

¹¹*Id.*

¹²*Id.*

¹³"China: Debt-to-equity swaps help steel makers," *China Daily* (Mar. 26, 2000).

¹⁴"China's Metallurgical Industry Profits Soar in Year to November," *Asia Pulse* (Jan. 23, 2001).

¹⁵U.S. Department of Commerce, *Report to the President: Global Steel Trade* at 146 (July 2000).

¹⁶National People's Congress, "Outline of the Ninth Five-Year Plan for Economic and Social Development" at Art. 4.2.4.2 (Mar. 17, 1996) (available at <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXXZLK&id=3506&pdm=rdgb>) (Chinese language document).

¹⁷State Economic and Trade Commission of China, "Tenth Five-Year Plan for the Metallurgical Industry" (Sept. 5, 2002) (available at <http://www.cas.cn/html/dir/2002/05/09/6332.htm>) (Chinese language document).

¹⁸*Id.* at Art. 3.3.1.

¹⁹*Id.* at Art. 3.3.1.3.

²⁰China National Development and Reform Commission, "Steel Industry Development Policy" (July 20, 2005).

key steel projects constructed in reliance of new domestically-developed installations.”²¹

- Further, “[t]he state provides export credit support to encourage steel manufacturing and equipment manufacturing enterprises to export domestic superior technologies and complete sets of metallurgy equipments by means of combining industry and trade or combining technology and trade.”²²
- The policy contains detailed plans for the shape and composition of the Chinese industry, calling, for example, for a reorganization of the steel industry by 2010 into a structure comprised of two 30 million MT steel groups and several 10 million MT groups.²³
- The policy micromanages many aspects of the Chinese steel industry, including the size of new steel plants, the location of such plants, and even the minimum size of blast furnaces to be installed.²⁴ The policy also bans all foreign companies from controlling Chinese steel companies.²⁵
- The policy declares that “[m]ineral resources belong to the state,”²⁶ and that “[t]he export of primarily processed products of coke, iron alloy, cast iron, scrap steel, steel billet (ingot) with high level of energy consumption and heavy pollution shall be restricted.”²⁷ Such restrictions suppress the price of steel inputs for Chinese producers.

Available evidence suggests that significant government resources are indeed continuing to flow to Chinese industry through the very kinds of subsidies identified in the steel policy. For example, the central government reportedly allows substantial income tax credits for companies that purchase domestically made equipment for technology upgrades.²⁸ Moreover, the central and provincial governments provide tax incentives for producers located in development zones. The U.S. State Department reports that five special economic zones, 14 coastal cities, hundreds of development zones and designated inland cities all promote investment with “unique packages of investment and tax incentives.”²⁹ Steel producers also reportedly receive subsidized raw materials and energy. In this regard, China’s government controls the price of gasoline and electricity, allowing manufacturers to obtain these vital items at subsidized prices.³⁰ And, government control of state-owned enterprises in a number of different sectors means these enterprises can make below-cost sales to one another.³¹ Provincial governments also reportedly subsidize steel inputs. In fact, just last year, the government of Shanxi province agreed to provide state-owned producer Shougang with coke and iron ore at a fraction of market value.³²

China’s widespread intervention in raw material markets is another area that has given rise to substantial concerns regarding ongoing benefits to, and effective subsidization of, Chinese steel producers. For example, China’s steel policy provides that China’s government may block “cut-throat competition” for resources.³³ In early 2006, there were numerous press reports regarding efforts by the Chinese government to influence negotiations between Chinese producers and global suppliers of iron ore—making clear that the government would “take necessary measures if prices were unacceptable and unreasonable.”³⁴ China’s imposition of export restrictions on coking coal in 2005 also caused extensive disruptions on world markets,

²¹*Id.* at Art. 16 (emphasis added).

²²*Id.* at Art. 27 (emphasis added).

²³*Id.* at Art. 20.

²⁴*Id.* at Art. 12 (providing that the blast furnaces shall be over 3,000 cubic meters, and that steel plants should have a capacity in excess of 8 million MT).

²⁵*Id.* at Art. 23.

²⁶*Id.* at Art. 28.

²⁷*Id.* at Art. 30.

²⁸State Tax Administration, *Technological Renovation of Domestic Equipment Corporate Income Tax Exemption Notice* (Jan. 17, 2000) (available at <http://www.jsgs.gov.cn/Page/statutedetail.aspx?statuteid=2965>) (Chinese language document).

²⁹U.S. & Foreign Commercial Service and U.S. Department of State, *Doing Business in China: A Country Commercial Guide for U.S. Companies* at 148 (2006).

³⁰USCC Hearing at 52 (Statement of Dr. Usha C.V. Haley, Director, Global Business Center, University of New Haven).

³¹*Id.*

³²“Shougang to Set Up Steel JV in Shanxi Province,” *Steel Bus. Briefing* (March 2, 2006).

³³See Steel Industry Development Policy at Art. 30 (“When several domestic enterprises engage in cut-throat competition for overseas resources, the state may exercise executive power to coordinate, organizing [an] industrial alliance or deciding one enterprise to invest so as to avoid cut-throat competition. The enterprises shall obey national executive coordination.”)

³⁴See, e.g., “China Stance Helped Limit Iron Ore Price Increase,” *Dow Jones International News* (June 21, 2006).

and led the EU to threaten potential action under the WTO to deal with the problem³⁵—which clearly served to artificially lower input costs for Chinese producers.³⁶

China's continuing policy to subsidize its steel industry is further reflected in the recent decision of the United States Trade Representative to commence WTO consultations with China with regard to nine WTO-prohibited export performance and import substitution subsidies. It is noteworthy that the Chinese steel industry was specifically identified as one of the key industries receiving support under these programs. These programs involve, among other things, preferential income tax and VAT treatment, below-market loans, and policies to encourage the use of domestic, rather than imported, materials.³⁷ While the specific WTO-prohibited subsidies identified by USTR represent only a small portion of the enormous level of state support that has been provided by the Chinese government, they are indicative both of the ongoing nature of the problem and the very clear evidence of WTO violations.³⁸

In sum, the evidence suggests that China's steel industry is the most heavily subsidized in the world (Figure 3).



Impact of Subsidies on World and U.S. Steel Markets

With all of this past and ongoing government support, it is not surprising that China's steel production expansion is unprecedented in the history of the global industry. In the time remaining today, I would like to focus my remarks on the impact of government support for Chinese steel industry—both on global and U.S. markets—and the steps needed to combat further distortion of global steel markets. The fact is that subsidies make a huge difference in the capacity and production decisions of companies, and can and do act to badly distort market outcomes. That is why it is imperative that policy makers take the problem seriously and act aggressively to combat it.

Chinese steel production has *exploded* over the course of the last decade—i.e., at the same time that many of the subsidies described above were reportedly granted

³⁵ See "China Continues Restriction Measure on Coke Export," *Asia Pulse* (June 24, 2005).

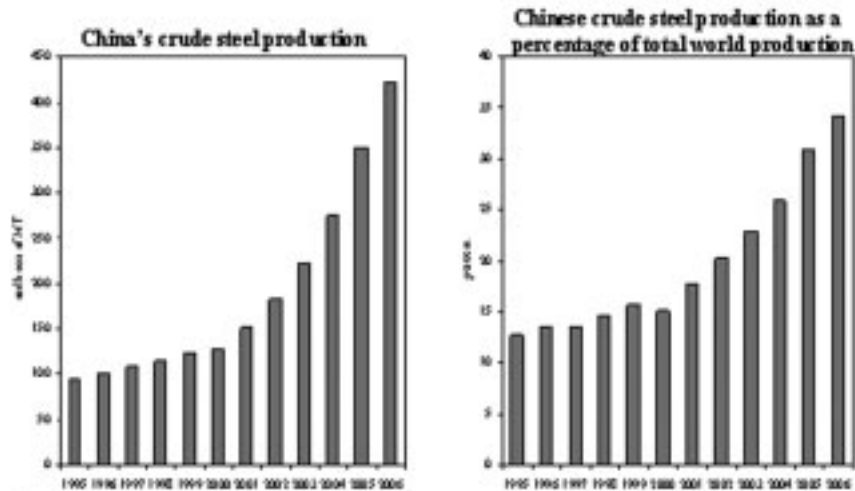
³⁶ World Trade Organization, "China's Transitional Review Mechanism: Communication of the United States, G/MA/W/71 at 3, para. 9 (Sept. 6, 2005).

³⁷ See United States Trade Representative, "United States Files WTO Case Against China Over Prohibited Subsidies," Press Release (Feb. 2, 2007).

³⁸ China's failure to adequately enforce basic labor and environmental standards has also, in the view of many, served to provide Chinese companies with an unfair advantage in international trade—and arguably served as a means of effective state support and subsidization.

(Figure 4). In fact, Chinese crude steel production more than *quadrupled* in the last ten years, growing from an estimated 100 million MT in 1996 to approximately 420 million MT in 2006. This is the rough equivalent of building *three entire American steel industries* in just one decade. Moreover, China's production growth has far outpaced growth in the rest of the world. China's share of world steel production skyrocketed from an estimated one-eighth in 1996 to over one-third in 2006, underscoring the unprecedented nature and enormous magnitude of what China is doing.

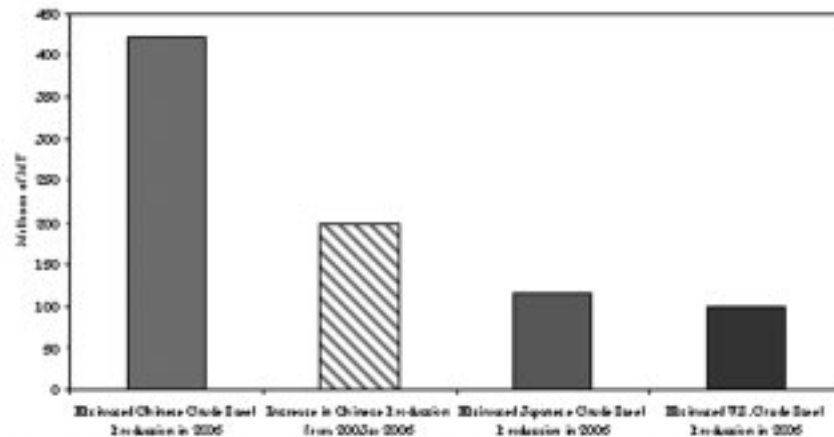
China's Crude Steel Production Is Exploding



Source: World Steel Dynamics, Steel Production of 19 (2006, 11, 2006)

And the situation is quickly deteriorating. In fact, the most colossal portion of China's steel production growth has occurred in just the last few years. Between 2003 and 2006, it is estimated that the *increase* in China's crude steel production alone was roughly equal to the *total* production of Japan or the United States in 2006 (Figure 5). It is likely no coincidence that these are the years immediately following some of the largest reported Chinese government payouts to the steel industry. Though we are still working to understand the full implications of this absolutely unprecedented industrial expansion, one fact is clear: the Chinese market is not able to support the hundreds of millions of tons of production capacity added in the last few years.

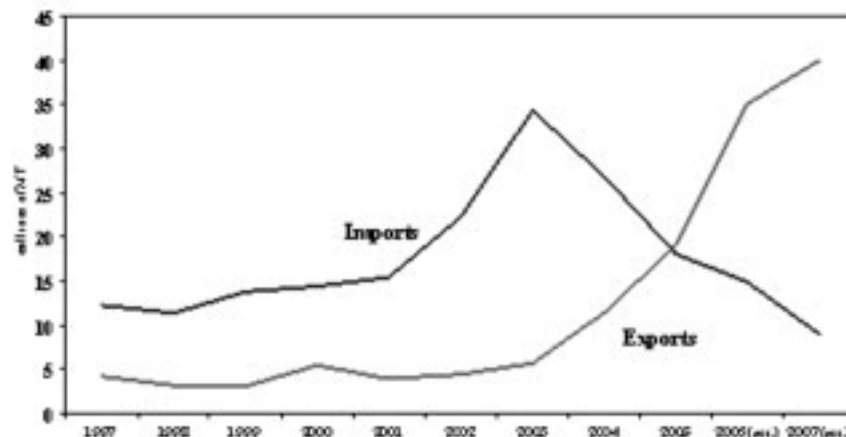
Over the Last Three Years, China's *Increase* in Steel Production Is Roughly Twice the *Total* Production in the United States or Japan



Source: Data for China taken from World Steel Dynamics, 2007 (Washington, D.C.: WSD, 2007). Data for Japan and the United States taken from the International Iron and Steel Institute web page. U.S. and Japanese statistics are of crude production from January to the end of 2006.

This is evidenced by the fact that Chinese imports are bottoming out while exports are skyrocketing, as Chinese producers seek markets for their surplus production (Figure 6). In 2003, China was a net importer of steel. Three years later, the situation flipped completely, and China became a net exporter. Indeed, China's steel trade balance shifted by nearly 50 million MT between 2003 and 2006 (Figure 7).

As Chinese Imports Fall, Chinese Exports Continue to Rise



Source: World Steel Dynamics.

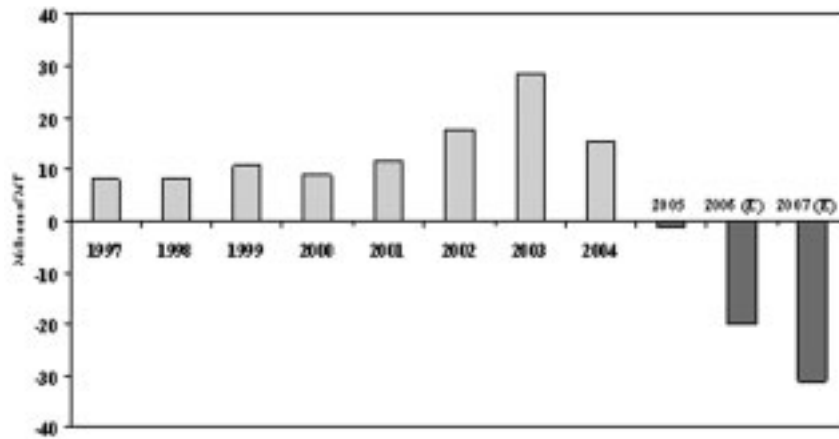
I cannot emphasize enough how extraordinary, unprecedented, and threatening these developments are. Let me walk you through the serious, real-world consequences for our industry. We are being inundated with surging volumes of Chinese imports. China shipped over 5 million NT of steel products to the United

States in 2006, more than double the level of Chinese imports in 2005 (Figure 8). By the end of last year, we were importing more steel from China than from any other country—including Canada. In fact, we were importing more steel from China than from *all 25 members of the EU combined*.

It is also very important to note that Chinese imports are no longer limited to low-end items. China is moving up the value chain, increasingly competing with some of our most advanced products, including corrosion-resistant sheet, oil country tubular goods, and cold-rolled sheet. These products are among the most valuable to the U.S. industry. And, as I discussed a few moments ago, Chinese state policy explicitly targets these high-value products for subsidization.

The U.S. industry is very competitive, especially with regard to these critical, high-value products. To give one example, U.S. corrosion-resistant steel producers increased their productivity by 78 percent from 2000 to the first half of 2006. We can compete with any steel producer in the world on market terms. But we simply cannot compete with China's government resources. And we should not have to. If China wants access to the markets of the world, it must play by the rules—and put a stop to market-distorting subsidies.

China's Net Imports of Steel Products, 1997 to 2007



Source: World Steel Dynamics, Global Steel Market Study, v3, 2006.

Need for Policy Action

In short, the China trade problem is grave, and the current trade imbalance—fueled by unfair practices—is unsustainable. The last thing we want is a repeat of the Asian crisis of the late 1990s, when overproduction abroad resulted in a flood of cut-rate imports that put the entire American steel industry at risk. The time for strong policy action to prevent another crisis is now.

USTR's recent initiation of WTO consultations with regard to certain Chinese subsidy programs is a step in the right direction. But I would like to again underscore that the nine subsidy programs identified by USTR are a very limited subset of the problem. In particular, the USTR's action involves only WTO-prohibited subsidies (i.e., so-called "export" or "import substitution" subsidies), the majority of which relate solely to foreign-invested enterprises. The USTR action does not in any way address the vast evidence of enormous "domestic" subsidies that built up many of China's largest steel enterprises over the past several years and continue to unfairly benefit Chinese producers today.

Again, the time to act is *now*, before the situation deteriorates beyond our ability to meaningfully address it. There are a number of crucial policy actions we believe Congress and the Administration must take to address this problem:

- First, it is absolutely critical that we *strictly enforce our trade laws*. With regard to China and all of the other trade threats America faces, this must be our highest priority. Our anti-dumping and anti-subsidy laws constitute in most instances our only practical line of defense against severe market-distorting practices that would otherwise allow foreign producers to overrun this market. In this regard, we need to ensure that China continues to be treated as a non-mar-

ket economy for purposes of our anti-dumping law—particularly given the extensive evidence that China continues to control many fundamental aspects of its economy. The first step of any China policy—and indeed any manufacturing policy—should be a “zero tolerance” policy for unfair trade.

- Second, we also urgently need *real China legislation*. There are some very obvious, easy steps that can be taken, such as *applying our anti-subsidy laws to China*. It simply makes no sense to exempt Chinese producers, particularly given the evidence that they are among the most heavily subsidized producers in the world. We also urgently need to do something real on *currency manipulation*. Letting China string us along with endless talk and tiny adjustments to the value of the yuan is no solution at all, especially in light of the enormous consequences of this flagrant manipulation. There are a lot of good ideas out there to address market-distorting behavior in China, and we sincerely hope that Congress will pursue them.
- Finally, it is imperative that we keep our AD/CVD laws strong in the face of relentless efforts to weaken them as part of international negotiations. We have seen such efforts to weaken our trade laws in the Doha round, and we are also seeing them in free-trade agreement (“FTA”) talks, such as the ongoing U.S.-Korea FTA negotiations. Weakening our trade laws as part of these talks could very well make them unworkable to combat unfair trade from China and other countries that disregard global rules. It is imperative that Congress send the clearest possible message that it will *reject any agreement that weakens our AD/CVD laws*.

Conclusion

We find ourselves at a critical moment. If we act now, we can guard our nation against further unfair Chinese trade and prevent another crisis impacting core American industrial sectors. Thank you for supporting American manufacturing and the American steel industry, and thank you for the opportunity to testify today.

Chairman LEVIN. Thank you.
Frank Vargo, welcome.

STATEMENT OF FRANKLIN J. VARGO, VICE PRESIDENT OF INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. VARGO. Thank you, Mr. Chairman, Mr. Herger, Members of the Subcommittee. I am very pleased to be here on behalf of the National Association of Manufacturers (NAM) to talk about China’s trade-distorting subsidies.

No other trade subject comes anywhere near China as far as commanding the attention of NAM companies. It is simultaneously the greatest concern of many of our import competing companies and one of the fastest growing markets for our exporters.

We want a positive and mutually beneficial and very productive trade relationship with China, but to do so, we have to see that the rules that China agreed to abide by are actually followed. We have a range of concerns, including currency, intellectual property theft, and subsidies.

Now, direct and indirect export subsidies have been a major concern for NAM members for some time. We have heard quite a few stories about Chinese products, for example, being imported into the United States for less than the cost of the raw materials.

One of our member companies, for example, makes hardware, and gave us an example of a pair of pliers that can be imported from China for a wholesale price of 49 cents, but the only problem here is there is 61 cents of raw materials in them. So, how does a Chinese company take those raw materials, machine them, assemble them, package them, ship them across the Pacific Ocean,

and sell them for 49 cents? One answer would be they were getting subsidies.

Now, as part of China's accession, China agreed to identify its prohibited export subsidies and to eliminate them. Now, 5 years later, they have finally identified a range of subsidies. USTR has been having discussions with them. Those discussions have not been productive. So, now we have the beginning of a trade case on those subsidies, and the NAM very strongly supports this.

As we look at some of these subsidies, we believe they can be very significant. I understand one subsidy, for example, is that if you export 70 percent or more of your output, that your income taxes are cut in half. That is pretty potent incentive.

They are not all export subsidies. On the other side, my understanding is that one of the Chinese laws is that if you buy Chinese-made equipment for your factory or your service facility that you get—you can write 40 percent of that off against your taxes. You get a 40 percent tax rebate. Well, that again is a pretty powerful subsidy, and it particularly affects American companies because we are a capital goods exporter. So, we would be able to sell more equipment to China if we didn't have to face these subsidies.

Then there are specific subsidies in industries—in machine tools, tool and die, casting and forging. These are industries from which we hear a lot of pain from our NAM members. There could be more subsidies coming.

We noted in the questions that the U.S. Government put to the Chinese at the WTO, among them was a statement that China's Ministry of Commerce is in the process of selecting a hundred Chinese auto or parts manufacturers to be designated as State-level auto and parts exporters who will be targeted for special financial and export credit support.

Now, we have no estimate of the overall effect that these subsidies are having, but we can see from the magnitude that they are very significant. Now, I know that a lot of people say Chinese wages are so low that nothing else matters; you just can't compete against them, but that is not so.

American manufacturers are very productive. As a matter of fact, we estimate that the average labor cost in a U.S. manufactured good is only 11 percent. Eighty-nine percent is the cost of materials, energy, taxes, distribution, marketing, and so forth, so that the concept that Chinese labor wages trump all is just not true. We need to press for the elimination of these subsidies. They are prohibited. They are illegal. They shouldn't be there. We shouldn't have to deal with them.

We want this just to be the beginning. These are the very visible prohibited subsidies. We want the USTR and the Commerce Department to investigate and press for more. We want to make sure that they have the resources to do so. Appropriations are not the jurisdiction of this Subcommittee or Committee, but we hope that you will work to ensure that all the resources they need are indeed provided.

Now, in addition, we believe that U.S. companies should be able to bring countervailing duty cases against Chinese subsidies. We have urged the Commerce Department to reverse its 20-year policy

of not applying countervailing duty provisions to non-market economies.

Now, the huge U.S. trade deficit with China continues to grow. Last year it was 232 billion, up from 205 billion in the year 2005. We have deficits with countries other than China, and we have an overall manufactured goods deficit of 530 billion. That is huge.

When we address these deficits and look at how we get them down, it is important that we deal with the facts. For example, it is not uncommon to hear that the three million manufacturing jobs lost in the United States were all due to increased imports. That is just not true. There are many factors involved.

Some were certainly lost to imports. Some were lost to the export collapse that we had a couple of years ago. It is also very true that we have been very, very productive in recent years. As a matter of fact, if you look at the two graphs attached to the last page of my prepared statement, you will see that both in terms of the Federal Reserve Board's production index and in terms of the manufacturers' factory shipments from the Census Bureau, that we are at an all-time high, and our 14 million workers today are product more than 17 million workers produced five years ago.

That is not to say we don't have a problem at all. We do. We have too large a trade deficit. We have too large a trade deficit with China. We should not put up with WTO-inconsistent practices like these subsidies.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Vargo follows:]

Statement of Franklin J. Vargo, Vice President of International Economic Affairs, National Association of Manufacturers

Mr. Chairman and Members of the Committee:

I am pleased to testify today on behalf of the National Association of Manufacturers (NAM), the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. We seek a vibrant, globally competitive manufacturing industry in the United States.

No other trade subject comes close to commanding the attention that China is getting from NAM companies. China is simultaneously the greatest concern of many of our import-competing members and the fastest-growing global market for large and small exporters and for many companies that operate internationally. China has emerged within a short span of two decades as a strong international competitor in a wide range of manufactured products and a key market for U.S. manufactured exports.

The NAM seeks a positive and mutually-productive trading relationship with China that reflects market forces as closely as possible. China's emergence as a leading world economy has meant significant new opportunities for many NAM members, including increased exports and investment. At the same time, many import-competing U.S. manufacturers see prices of Chinese products so low—sometimes even lower than the cost of the raw materials—that it is difficult for them to see how they can compete. Others see their customers moving to China and cannot find new ones to replace them.

The NAM's concerns with China cover a range of issues, including protecting intellectual property rights, maintaining a currency value that reflects the strength of the Chinese economy and ending prohibited government subsidization of industry.

We are also concerned that we are seeing a growing Chinese industrial policy that favors domestic producers, making it more difficult for foreign firms to participate in the Chinese economy. While currency and intellectual property theft are huge problems for NAM members and for our trade balance with China, I will confine my remarks in this testimony to China's subsidies.

The NAM worked hard to support China's membership in the World Trade Organization (WTO), and we remain fully supportive of that membership. Bringing China into the WTO required it to begin following the same trade rules as the rest of the world and to open its markets more fully. It has now been over five years

since China joined the WTO and it is important that China implement its obligations fully.

There have been many positive benefits. Joining the WTO has encouraged China to open its internal market to international trade and foreign investment and adopt more market-oriented policies for developing its economy after decades of state control and management. At the same time, WTO agreements and principles have provided internationally accepted standards for guiding and evaluating China's policies affecting trade.

China has now been in the WTO five years, and the NAM concurs with the Administration's 2006 Top to Bottom Review of China Trade Policy that as a mature trading partner, China should be held fully to its commitments. Unlike most other WTO members, China presents a unique challenge for evaluating its WTO compliance. While the Chinese economy has evolved significantly from a state-controlled model, it is still not a market economy. Both the national government and local governments play a significant role, directly and indirectly, in determining business decisions and limiting competition in the marketplace. Some of these policies appear to be driven by economic policy goals aimed at artificially accelerating China's industrial growth and export of manufactured goods.

The rule of law is essential to the free flow of trade in goods and services and governments have a responsibility to adhere to their commitments under the WTO and other international agreements. When governments interfere in trade in violation of the rules, enforcement is important to prevent the growth of distortion in global markets. The NAM believes that the area of subsidies is no exception and, in 2004 and subsequently, the NAM Board of Directors has supported legislation in Congress that would state clearly that U.S. countervailing duty law should apply to both market and non-market economies.

Often U.S. companies can only surmise that inappropriate policies are in place because they know that manufacturers operating on market principles would not engage in similar practices (e.g., selling a product at below the international price for the raw material input or continuing to build new capacity when there is already oversupply on the market.)

To ensure effective WTO compliance, U.S. agencies must be prepared to investigate trade problems even when there is limited documentation and other hard evidence that a violation of trade rules has occurred. The NAM believes strongly in the rules-based trade system. As with any country, when there are violations of trade rules, U.S. companies should have recourse to WTO-consistent remedies under U.S. trade law.

The use of and access to legitimate trade law in cases where it is warranted is necessary for mutually beneficial trade and is the best defense against the growth of protectionism. If affected companies have recourse when faced with unfair trade practices, there is a basic sense that trade works to their benefit.

Direct and Indirect Industry and Export Subsidies

Direct and indirect industry and export subsidies are a major concern of U.S. manufacturers, particularly those that compete against Chinese-made products. Member companies and organizations have long complained to us that Chinese enterprises must be receiving subsidies because they appear to be selling their products in the United States at below the cost of raw materials and shipping.

One of our member companies that makes hardware provides a typical example. Their large retail customers in the United States are able to purchase a particular pair of Chinese-made pliers for 49 cents. The U.S. company makes virtually identical pliers, but the problem is that the raw materials' cost in these pliers is 61 cents. This is not the sales price of the U.S. pliers—just the cost of the raw materials. How is it possible for a Chinese company to take 61 cents of raw materials, process them into pliers, package them, ship them across the ocean, and sell them for 49 cents? One way would be if the Chinese company were receiving subsidies.

In 2001, China acceded to the WTO and agreed to be bound by its provisions, expressly including the Subsidies and Countervailing Measures (SCM) agreement. As part of China's accession, the Chinese government acknowledged the existence of subsidies and agreed to notify its subsidies to the WTO, and to terminate its prohibited subsidies upon accession. Last April, several years after it was due, China finally notified WTO members of government subsidy programs. China listed 78 subsidy programs for the period 2001–04 covering a wide range of programs.

China's list, appears incomplete, however, and did not include a variety of policies and programs that NAM members believe are giving substantial subsidies to Chinese industrial enterprises—such as those provided by China's state-owned banks or by provincial or local governments. Chinese enterprises, for example, appear to have access to the automatic roll-over of unpaid principal and interest; loan forgive-

ness; continued borrowing despite having non-performing loans; and below-market interest rates.

The SCM agreement defines two categories of subsidies: prohibited and actionable. The WTO defines prohibited subsidies as those that require recipients to meet certain export targets, or to use domestic goods instead of imported goods. They are prohibited because they are specifically designed to distort international trade. They can be challenged in the WTO dispute settlement procedure where they are handled under an accelerated timetable. If the dispute settlement procedure confirms that the subsidies are prohibited, they must be withdrawn.

At the beginning of this month, after bilateral consultations with China made little progress, the U.S. Trade Representative (USTR) initiated dispute settlement proceedings against China, for what appear to be prohibited export subsidies that China should have terminated, but did not. The NAM strongly supports this action and urges that the proceedings be moved forward as rapidly as possible.

For this initial case, USTR has chosen to focus on “prohibited subsidies.” No evidence of an adverse effect is necessary in the case of prohibited subsidies, unlike the situation in actionable subsidies. A prohibited subsidy is prohibited. Period. All that need be established in the case that is now being brought is that the Chinese subsidies in the complaint fit the definition of a prohibited subsidy.

As we have looked at some of the subsidies in the complaint, there does not seem to be much question that these subsidies are prohibited. For example, I understand that in the case of one measure, enterprises that export at least 70 percent of their production may be able to enjoy a corporate income tax rate of 15 percent or lower rate instead of the normal 30 percent rate. That is a very significant subsidy and certainly can distort trade patterns in a way that would affect U.S. imports.

I would like to comment in more detail about a number of subsidies being granted to manufacturers that are illustrative of Chinese subsidization.

Equipment Generally: Not all of the subsidies being challenged in this WTO are export-oriented. Import-distorting subsidies are also included. For example, both foreign firms and domestic firms in China apparently get a tax write-off if they buy Chinese equipment for their factories or business installations instead of purchasing imported equipment. My understanding is that this takes the form of an income tax refund equal to 40 percent of the value of the equipment purchased. That is a huge incentive to buy domestically-made equipment rather than imports—and definitely would be a prohibited subsidy.

Machine Tools: Additional subsidies appear to target particular industries that the Chinese government wants to develop by giving them preferred access to China’s domestic market. One NAM member, for example, told us that 70 Chinese machine tool companies making computer numerically controlled (CNC) machine tools and related products can have 50% of the value-added tax (VAT) rebated to them.

As the VAT tax is 17%, this is quite an incentive for them to lower their prices and distort competition by tilting the playing field against U.S. and other exporters. The machine tool subsidy is of particular concern as China is proving an increasingly difficult market to sell in to and Chinese exports of machine tools to the United States are growing rapidly.

Tool and Die: The U.S. tool and die industry has a huge competitive problem with Chinese companies, and China’s notification to the WTO shows that if Chinese producers buy die products produced by one of 160 specified Chinese die manufacturers, they will get 70 percent of their VAT tax refunded.

Casting and Forging: Another U.S. industry that is having a very difficult time competing against China is the casting and forging industry. China’s notification to the WTO stated that if Chinese purchasers bought casting or forging products from one of 284 specialized Chinese casting and forging companies rather than purchasing foreign imports, they could get a refund equal to 35 percent of the VAT paid on those products.

Autos and Auto Parts: And yet even newer subsidies may be under development. In questioning China’s subsidy submission to the WTO, the U.S. noted that “China’s Ministry of Commerce (MOFCOM) is in the process of selecting 100 Chinese auto or parts manufacturers to be designated as ‘state-level auto and parts exporters’ who will be targeted for ‘financial and export credit support.’”

While we have no estimate of the overall effect these and other subsidies are having, we believe the effect is likely to be very substantial. The United States tends to be an exporter of capital equipment, rather than consumer goods, so subsidies that put imports of capital equipment into China at a disadvantage have a potentially strong effect on U.S. exports. This includes many small U.S. companies. In 2005, the latest year for which data are available, 22,000 small and medium-size U.S. firms exported to China, up 50 percent in the time since China joined the WTO. This number has likely continued to grow rapidly since 2005. As these small-

er companies attempt to establish a marketing position in China, they already face ample obstacles without having to compete against subsidized Chinese firms.

Some commentators have stated that Chinese wages are so low that little else counts in competing with China. They overlook the fact, however, that labor costs are only one factor in the production process. U.S. manufacturers are highly efficient, with strong labor productivity. In fact, Census Bureau data show that production worker wages and benefits on average are only 11 percent of the cost of U.S. manufactured goods—with 89 percent of the production cost being materials, energy, overhead, marketing, distribution, profits, taxes, and the like. We recognize that U.S. manufacturers need to work with our own government to make the U.S. manufacturing environment a competitive one. However, the idea that low Chinese labor rates trump all is not true.

The U.S. government needs to press for the quick elimination of the subsidies identified in the case just filed with the WTO. In addition, the NAM wants USTR and the Commerce Department to continue seeking information on other possible subsidies, in the form of loan forgiveness and other forms of subsidy. Many of these subsidies may not be “prohibited” and may fall in the “actionable” category requiring considerable evidence of damage. The NAM hopes this subcommittee will inquire as to whether those two agencies are adequately staffed and funded for this exercise, and if not, we hope the subcommittee will encourage the relevant appropriations committees to ensure an adequate funding level.

In addition, the NAM believes that U.S. companies should be able to bring countervailing duty cases against Chinese subsidies, and we have urged the Commerce Department to reverse the 20-year policy of not applying countervailing duty law in the case of non-market economies. There are two reasons for a change in policy: first, when the Subsidies and Countervailing Measures agreement was modified in 1994, the definition of a subsidy was changed from one that looked at effects to one that defined subsidies by what they are. Second, when China joined the WTO, it expressly agreed to be bound by the terms of the Subsidies and Countervailing Measures agreement, even agreeing to special methodologies for use in assessing subsidies its non-transparent economy.

The NAM supported HR 3283 in the 109th Congress, a bill that sought to clarify the intent of Congress as being that countervailing duties should be applicable to subsidies from non-market economies as well as market economies. The NAM continues to support that concept, though we seek some technical changes to last year’s bill.

Finally, subsidized foreign investment is an issue that should be explored. WTO agreements have long recognized that subsidies unfairly distort trade in goods. The Agreement on Subsidies and Countervailing Measures (ASCM) subjects those subsidies to disciplines and provides remedies. Similarly, governments recognize that subsidies related to trade in services distort markets and should also be addressed. Article XV of the General Agreement on Trade in Services (GATS) acknowledges that subsidies may distort trade in services. The GATS obliges WTO member countries to enter into future negotiations on the subject and to give “sympathetic consideration” to complaints.

Subsidies for the acquisition of assets distort the market for those assets in much the same manner as trade subsidies. The United States has long been an advocate for increased disciplines on subsidies, including market-distorting practices that may escape the current rules (such as government-directed credit) and stricter disciplines to address certain types of adverse effects that are not adequately dealt with under the current rules (e.g., overcapacity caused by subsidies in the steel and fisheries sectors). New consideration needs to be given to how we handle subsidized investment in the future.

Putting China—and Trade—In Perspective

The huge U.S. trade deficit with China is continuing to grow. Data just released by the Commerce Department show the 2006 merchandise trade deficit with China was \$232 billion up from \$202 billion in 2005. China now accounts for over 40 percent of our global non-petroleum trade deficit.

Export growth to China is rapid, but starts from a small base. Last year’s 32 percent increase in exports to China resulted in a dollar growth of \$13 billion. The 18 percent import growth, though, resulted in a \$44 billion increase. As imports from China are five times as large as exports to China, a significantly higher export growth rate relative to the import growth rate is needed to stabilize and then bring down the deficit.

It is noteworthy, though, that the increase in the deficit last year was 15 percent, significantly below the 25 percent growth that has been seen for some time. Now I am not implying that this is “break out the champagne” news, but it is the first

time we have seen a slowing in the growth rate of our deficit with China. Nevertheless, the size of the deficit and its continued growth underscore the need to utilize our trade rights to eliminate subsidies and other distortions of trade with China.

We have deficits with countries other than China, of course, and our global manufactured goods trade deficit in 2006 was nearly \$530 billion. But as we address these deficits, we must be realistic about the effect they are having on our economy. It is important that we all move forward with as good a grounding in the facts as possible.

For example, it is not uncommon to hear that U.S. manufacturing is on its last legs, that we have been hollowed out and that our production base has moved overseas. A look at the factory shipments and industrial production data I have included as the last page of my testimony shows this is not true. Measured by historical standards and recent trends, U.S. manufacturing output is strong. This is not, of course, the case for all sectors. While some are doing very well, others are not. And within sectors some companies are doing well, while others are struggling to stay afloat.

American manufacturing faces many problems and challenges. Global competition is one, both in terms of import competition and in terms of having to face trade barriers around the world and too many unfair trade practices. But we have home-grown problems as well, in terms of higher costs from taxes, regulation, energy costs, etc. In fact, when we ask our member companies to name their biggest problem, they tell us that health care costs and a shortage of skilled workers is at the top of their list.

Some believe all our problems stem from trade, and that trade is the reason that manufacturing has lost 3 million jobs in recent years. Some commentators are fond of pointing out that the United States lost 3 million jobs in the "NAFTA-WTO decade." The clear implication is that NAFTA and trade generally are the cause of the 3 million job loss. But that is untrue.

It is certainly true that between 2001 and 2003 nearly three million manufacturing jobs were lost—a huge number, close to one in every six jobs. The jobs have not come back since that time, with manufacturing employment trending down gradually since 2003. But since the U.S. manufactured goods deficit with NAFTA in 2001 was \$38 billion and the 2006 manufactured goods deficit with NAFTA was also about \$38 billion, how could the job loss have been caused by NAFTA? Since there was no increase in the manufactured goods deficit with NAFTA, it is hard to see what kind of analysis would indicate NAFTA as the cause of our job loss.

Many people are startled to learn that the manufactured goods deficit with NAFTA is no larger than it was in 2001, for they look at the overall trade figures with NAFTA and see a \$55 billion increase since 2001. However, this increase was entirely due to oil imports. Mexico and Canada supply one in every three barrels of oil we import from the world, and with the price of oil being what it is, the petroleum deficit with them has soared—growing \$55 billion.

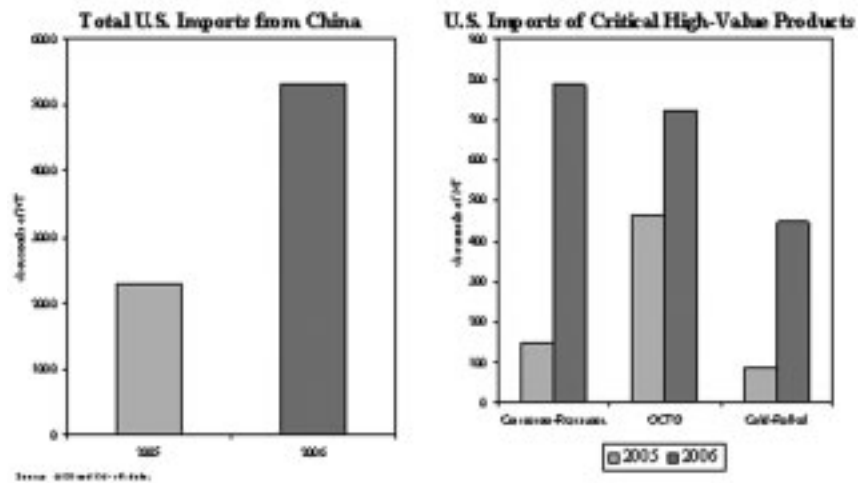
Looking at the trade deficit more broadly, Dr. Lawrence Michel, President of the Economic Policy Institute, testified before the full Ways and Means Committee at the end of January that, "In just the five years from 2000 to 2005, more than three million manufacturing jobs disappeared. We estimate that at least one-third of that decline was caused by the rise in the manufactured goods trade deficit."

That is possible, as in the period when those 3 million jobs were lost, there was a big jump in our global manufactured goods deficit—a \$90 billion increase, in fact. But the inference most people seem to draw from this is that it was imports that caused that job loss—particularly U.S. multinational imports from low-wage countries. But that is not what the figures show. The data show that the \$90 billion increase in the manufactured goods deficit in that period was due to a \$20 billion increase in imports, and a *\$70 billion drop in exports*. Thus, to the effect that trade was a factor in the job loss, about 80 percent of the trade impact came from falling exports, not rising imports.

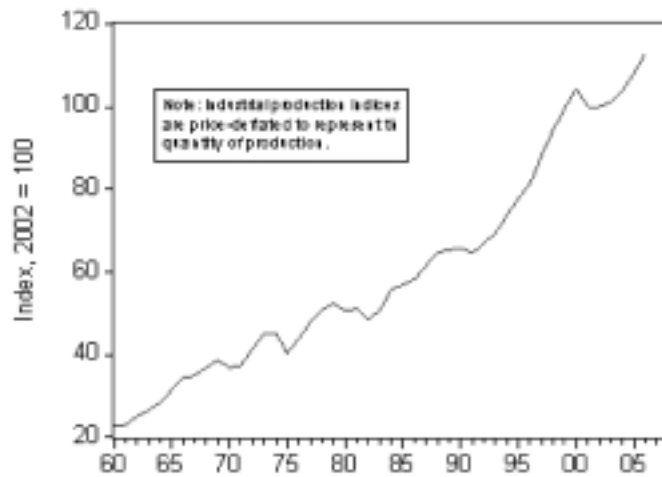
None of this is to say that U.S. manufacturing doesn't face serious problems—including from import competition from China. We do, but as we approach these problems we must do so armed with the facts and with an understanding of how we got where we are and how best to solve our problems so we can have the vibrant and growing manufacturing sector this country cannot survive without. Manufacturing is how we will pay our way in the world and manufacturing is the principal source of the innovations and productivity that we need for continued increases in our standard of living.

Thank you, Mr. Chairman, for holding this important hearing, and the NAM looks forward to continuing to work closely with you, other members of the committee, and the committee's excellent staff.

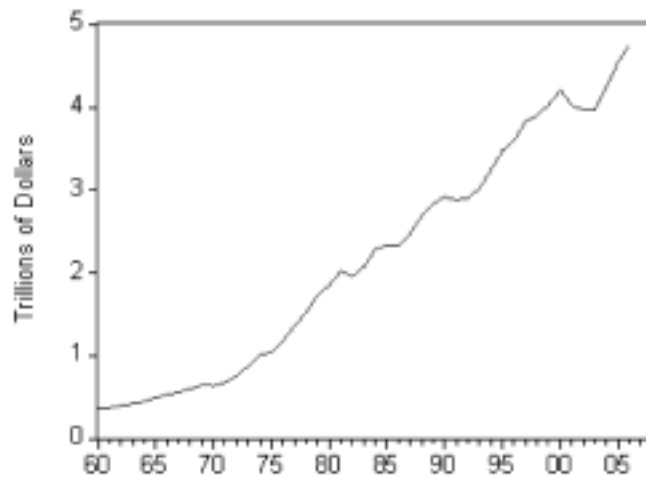
Within the Last Year, U.S. Producers Have Been Hit with a Flood of Chinese Imports



Chairman LEVIN. Thank you very much.

INDEX OF DOMESTIC U.S. MANUFACTURING PRODUCTION

Source: Federal Reserve Board

U.S. FACTORY SHIPMENTS OF MANUFACTURED GOODS

Source: Manufacturing, Mining, and Construction Statistics,
U.S. Census Bureau

NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Bassett.

**STATEMENT OF JOHN D. BASSETT, III, CHAIRMAN AND CHIEF
EXECUTIVE OFFICER, VAUGHAN-BASSETT FURNITURE COM-
PANY, GALAX, VIRGINIA**

Mr. BASSETT. Thank you, Mr. Chairman and Members of the Subcommittee. Good morning. My name is John Bassett. I am the Chairman of Vaughan-Bassett Furniture Company headquartered in Galax, Virginia. Vaughan-Bassett was founded by my family in 1919. We employ over a thousand workers at our furniture plants in Galax, Virginia and Elkin, North Carolina.

I am also the Chairman of the American Furniture Manufacturers Committee for Legal Trade. The Committee for Legal Trade has 22 member companies that produce bedroom furniture in the United States. I am testifying today on behalf of Vaughan-Bassett and the Committee for Legal Trade.

Beginning in about 2001, U.S. imports of wood bedroom furniture from China began to flood the U.S. market. In most cases, the Chinese producers did not offer anything new; they simply copied furniture styles that we were already successfully making for the U.S. market and offered them at much lower prices. Furniture became China's number one export to the United States, measured by the number of containers shipped. As a result, our industry lost enormous sales and a large share of our market to cheap imports from China.

In 2003, we learned for the first time that a trade remedy law, the anti-dumping law, was available to combat unfair priced imports. We formed the Committee for Legal Trade and filed an anti-dumping petition against imports of wood bedroom furniture from China in October 2003.

Given the Commerce Department's longstanding practice not to apply the countervailing duty laws to non-market economies or countries, we did not file a countervailing duty petition against the Chinese government subsidies.

In our anti-dumping case, the U.S. International Trade Commission investigated the impact of dumped imports from China during January 2001 through June 2004. During that period, imports from China, having a landed value of about 3.8 billion, contributed to the closing of over 65 U.S. furniture factories that made bedroom furniture—today that figure is much higher—and that employed over 18,000 workers. The Commission made a unanimous decision in late 2004 that our industry was materially injured as a result of dumped imports from China, and an anti-dumping order was imposed.

Now let me come to the heart of the matter. I speak for all of our members by saying, first, we would like to stay in domestic manufacturing in this country. Two, as an organization, we have supported NAFTA and we have supported the General Agreement on Tariffs and Trade. We were prepared, and are still prepared, to compete in a global marketplace. We have modernized our factories. We have increased our efficiencies. We have improved our quality. We have done all those things.

It was our understanding that our Government would provide a level playing field for us. Our job was to compete; our government's job was to create a playingfield that was level. Now, with dumping,

subsidies, and pegged currencies, we question today if that playingfield is level.

Here is a problem I have. How am I going to look my workers in the eye and tell them they no longer have a job, and it is a result of illegal trade? That is a hard thing to do. I have got to be able to look them in the eye as a corporate citizen and tell them truth. The truth is, I have done everything in my power to legally protect your job.

So, if the Administration will not do this, ladies and gentlemen, as a corporate citizen I only have one other place to come, and that is to my elected representatives, the U.S. Congress.

Now, in final, I am not asking for a bailout. I am not asking for a handout. I am not asking for a gift. We are asking for one thing: Let us do our job, and would you please do yours. Thank you very much.

[The prepared statement of Mr. Bassett follows:]

**Statement of John D. Bassett, III Chairman and Chief Executive Officer,
Vaughan-Bassett Furniture Company, Galax, Virginia**

Mr. Chairman, Mr. Herger, and Members of the Subcommittee:

Good morning. My name is John D. Bassett. I am the Chairman of Vaughan-Bassett Furniture Company, headquartered in Galax, Virginia. Vaughan-Bassett was founded by my family in 1919. We employ over 1,000 workers at our furniture plants in Galax, Virginia and Elkin, North Carolina. I am also the Chairman of the American Furniture Manufacturers Committee For Legal Trade. The Committee For Legal Trade has 22 member companies that produce bedroom furniture in the United States. I am testifying today on behalf of Vaughan-Bassett and the Committee For Legal Trade.

Beginning in about 2001, U.S. imports of wooden bedroom furniture from China began to flood the U.S. market. In most cases, the Chinese producers did not offer anything new; they simply copied furniture styles that were already successful in the U.S. market and offered them at much lower prices. Furniture became China's number one export to the United States, measured by the number of containers shipped. As a result, our industry lost enormous sales and a large share of our market to cheap imports from China.

In 2003, we learned for the first time that a trade remedy law—the antidumping law—was available to combat unfairly priced imports. We formed the Committee for Legal Trade and filed an antidumping petition against imports of wooden bedroom furniture from China in October 2003. Because of the Commerce Department's long-standing practice not to apply the countervailing duty law to non-market economy countries, we did not file a countervailing duty petition against Chinese government subsidies.

In our antidumping case, the U.S. International Trade Commission investigated the impact of dumped imports from China during January 2001–June 2004. During that period, imports from China, having a landed value of about \$3.8 billion, contributed to the closing of over 65 U.S. furniture factories that made bedroom furniture and that employed over 18,000 workers. The Commission made a unanimous determination in late 2004 that our industry was materially injured as a result of dumped imports from China, and an antidumping order was imposed in January 2005.

Although the Commerce Department determined in its investigation that imports from China were being dumped, the dumping margins it calculated were disappointing. The average dumping margin, and resulting antidumping duty, was only about 7 percent. That duty has certainly helped, but it has not come close to offsetting the amount by which the Chinese prices undercut our prices. Also, the antidumping duty has done nothing to offset the subsidies granted by the Chinese government to its furniture industry.

Since filing our antidumping petition, we have learned that Chinese subsidies for furniture makers include numerous tax breaks for exporters, for companies located in specially designated economic development zones, and for the purchase of machinery. Other subsidies include free-land use to attract investment, reduced duties on material inputs, and monetary incentives provided as part of an export promotion program. Input suppliers such as lumber companies also receive substantial

subsidies, including more than \$3 billion in grants in 2001–2004, low-cost and even interest free loans, debt forgiveness, and numerous tax breaks. These subsidies to upstream suppliers are particularly important because China does not enjoy any natural competitive advantage in timber, but the Chinese government has decided to create advantages by funding the development of fast-growth forests and processing facilities.

Mr. Chairman, wooden furniture is made from lumber, which comes from trees. The Chinese government owns the land where the trees grow, owns many of the mills which produce the lumber, and owns many of the factories that produce the furniture. It subsidizes the operations that it does not own. In addition, the Chinese government manipulates and undervalues its currency, giving its furniture exporters a 30–40 percent price advantage on top of all of the other subsidies.

These government preferences allow Chinese furniture producers to sell their products at extremely low prices, resulting in injury to U.S. furniture makers and U.S. workers. As a businessman, it makes no sense to me that the U.S. government would not apply all available trade remedies to imports from China. Giving China a free pass when it comes to subsidizing their export-oriented industries is neither good trade policy nor good economics, especially when the U.S. trade deficit with China is at record levels.

The American Furniture Manufacturers Committee for Legal Trade and Vaughan-Bassett Furniture urge this Committee to make sure that Commerce applies the countervailing duty law to China and to do all that it can to make our trade laws stronger to address dumped and subsidized imports from China.

Chairman LEVIN. Thank you.
Mr. Tyrone.

**STATEMENT OF JAMES C. TYRONE, SENIOR VICE PRESIDENT
OF SALES AND MARKETING, NEWPAGE CORPORATION, DAY-
TON, OHIO**

Mr. TYRONE. Mr. Chairman, Mr. Herger, Members of the Subcommittee, I would like to thank you for the opportunity to appear before you today on the issue of trade with China. My name is Jim Tyrone and I am Senior Vice President of Sales and Marketing at NewPage Corporation.

NewPage was founded in 2005 when the company purchased certain of the paper assets of MeadWestvaco. NewPage produces several types of paper, including coated free sheet, a high-end paper used in annual reports, promotional brochures, and other types of publications. NewPage is headquartered in Dayton, Ohio and we have production facilities in Rumford, Maine; Wickliffe, Kentucky; Luke, Maryland; and Escanaba, Michigan; and a converting and distribution facility in Chillicothe, Ohio.

Coated free sheet paper is a multi-billion dollar U.S. industry. NewPage itself employs over 4,000 workers in the United States. I would like to speak specifically today about subsidies to coated paper manufacturers in China, and the critical need for the United States Government to address and offset these subsidies by using all tools at its disposal, including U.S. countervailing duty law.

Unfair foreign competition has made it increasingly difficult for us to maintain the optimism we had at the founding of our company. In fact, NewPage recently had to permanently shut down an entire paper line at its Luke, Maryland facility as a result of unfair foreign competition.

The government of China provides very significant subsidies to its domestic paper producers, and these subsidies are injuring competing U.S. paper producers. Starting in the late nineties, the gov-

ernment of China targeted its domestic coated paper industry for rapid development. As part of this development plan, the Chinese government provides low-cost policy loans through government-owned banks. It also provides grants for the development of new paper capacity, and tax breaks based on export performance and domestic equipment purchases.

Moreover, government banks in China forgave at least \$660 million in loans they had provided to China's largest paper producer, Asia Pulp & Paper, when that company declared bankruptcy in 2003. These subsidies have had the effect of vastly expanding China's capacity to produce coated free sheet paper. As a result, in the United States, Chinese coated free sheet market share has increased by an average of 75 percent annually over the past 4 years based on publicly available data despite having to ship their products thousands of miles to reach the U.S. market.

In the face of increased unfair foreign competition, NewPage filed anti-dumping and countervailing duty cases on coated free sheet paper against China and two other countries, South Korea and Indonesia, in October of last year. In December, the International Trade Commission reached a preliminary determination that the United States industry is being injured as a result of the dumped and subsidized imports from these countries. The Department of Commerce is now in the midst of its own investigation of the cases.

The Department of Commerce investigation into subsidies to Chinese paper producers is a historic one. In the mid-eighties, Commerce found that it could not apply the countervailing duty law to address subsidies in Czechoslovakia and Poland based on its conclusion that subsidies in these non-market economies did not make sense at that time.

However, much has changed in the global trade regime over the last 20 years. China has become the world's third largest exporting economy, and the current economic system in China is vastly different than the command economies of the former Soviet bloc countries.

Also, as noted earlier, China joined the WTO in 2001, at which time it agreed to abide by global trading rules, including the rules on subsidies, in exchange for increased access to foreign markets. Moreover, while China retains many of the elements of a non-market system, it has also instituted policies to effect the development of particular industries through a host of subsidy programs. Basically, China is a highly subsidized non-market economy.

Commerce has the authority to apply countervailing duty law to China right now, and should do so. Recently the People's Republic of China (PRC) argued in the context of our case on coated free sheet paper that the Commerce Department is legally prohibited from applying the countervailing duty law to imports from China.

It is inconceivable to me that China would expect to garner all the benefits from WTO membership and yet argue that it is not bound by the responsibilities that WTO participation carries with respect to subsidies, responsibilities it specifically agreed to in 2001.

I would urge the Members of this Committee to help ensure a level playingfield by making clear to the Department of Commerce and to the People's Republic of China that the countervailing duty

does in fact apply to China. I thank you for your attention and would be pleased to answer any questions.

[The prepared statement of Mr. Tyrone follows:]

Statement of James C. Tyrone, Senior Vice President of Sales and Marketing, NewPage Corporation, Dayton, Ohio

Mr. Chairman, Mr. Herger, and Members of the Subcommittee:

I would like to thank you for the opportunity to appear before you here today on the issue of trade with China. My name is Jim Tyrone and I am the Senior Vice President for Sales and Marketing at NewPage Corporation. NewPage was founded in 2005, when the company purchased certain of the paper operations of MeadWestvaco. NewPage produces several types of paper including coated free sheet, a high end paper used in annual reports, magazines, promotional brochures, coffee table books and other types of publications. NewPage is headquartered in Dayton, Ohio, and has production facilities in Rumford, Maine; Wickliffe, Kentucky; Luke, Maryland; and Escanaba, Michigan; and a converting and distribution facility in Chillicothe, Ohio. Coated free sheet paper is a multibillion dollar United States industry. NewPage itself has more than 4000 employees in the United States. I would like to speak specifically today about subsidies to paper producers in China, and the critical need for the United States government to address and offset these subsidies by using all the tools at its disposal including the U.S. countervailing duty law.

NewPage was founded with a great deal of optimism about the future. In addition to being the largest coated paper manufacturer in the United States, we have efficient, state-of-the-art mills, skilled and dedicated employees, strong relationships with our customers, strategically located mills and distribution facilities and growing markets for our products. However, unfair foreign competition has made it increasingly difficult for us to feel optimistic. In fact, NewPage recently had to permanently shut down an entire paper line at its Luke, Maryland facility as a result of unfair foreign competition.

The government of China provides very significant subsidies to its domestic paper producers, and these subsidies are injuring competing U.S. paper producers. Starting in the late 1990's the government of China targeted its domestic coated paper industry for rapid development. As part of this development plan, the Chinese government provides low-cost policy loans through government-owned banks. It also provides grants for the development of new paper capacity, and tax breaks based on export performance and domestic equipment purchases. Moreover, government banks in China forgave at least \$660 million in loans they had provided to China's largest paper producer, Asia Pulp & Paper, when that company declared bankruptcy in 2003. The PRC has also fostered the development of timber and pulp production in China—the key inputs into paper production—with similar subsidized incentives. These subsidies have had the effect of vastly expanding China's capacity to produce coated free sheet paper. Much of this subsidized production finds its way into export markets, particularly the U.S. market, the most open in the world. Government subsidies allow Chinese producers to sell at very low prices, permitting them to undercut prevailing prices in the United States, and in third country markets. This, in turn, has allowed Chinese producers to dramatically increase their global market share. In the United States, Chinese coated free sheet market share has increased by an average 75 percent annually over the past four years based on publicly available data, despite having to ship their products thousands of miles to reach the U.S. market. Ironically, and in contrast to U.S. paper producers, China has no natural advantage in the production of paper. It does not have an abundant supply of the requisite inputs, and must import much of the pulp that it uses to make paper. As a result, the government of China is now essentially underwriting the development and expansion of fast-growth forests in China, to provide the timber and pulp that their huge paper companies now need to produce paper.

In the face of increased unfair foreign competition, NewPage filed antidumping and countervailing duty cases on coated free sheet paper against China, and two other countries, South Korea and Indonesia, in October of last year. In December, the International Trade Commission reached a preliminary determination that the United States industry producing coated free sheet paper is injured as a result of dumped and subsidized imports from these countries. The Department of Commerce, which has the responsibility to investigate allegations of dumping and subsidization, is now in the midst of its own investigation.

The Department of Commerce investigation into subsidies to Chinese paper producers is an historic one. In the mid-1980's, Commerce found that it could not apply

the countervailing duty law to address subsidies in Czechoslovakia and Poland, based on its conclusion that subsidies in those “nonmarket” economies did not make sense at that time. Commerce has not since applied its countervailing duty law to nonmarket economies. However, much has changed in the global trade regime over the last twenty years. China has become the world’s third largest exporting economy, and the current economic system in China is vastly different than the command economies of the former Soviet bloc countries. Moreover, China joined the WTO in 2001, at which time it agreed to abide by global trading rules—including the rules on subsidies—in exchange for increased access to foreign markets. Moreover, while China retains many of the elements of a nonmarket system, such as a pegged exchange rate, control over labor and lending rates, and the prices of certain inputs, it has also instituted policies to effect the development of particular industries through a host of subsidy programs implemented at the central and local government levels. Basically China is a highly subsidized non-market economy. It is imperative that the United States utilize the countervailing duty law to address these subsidies.

Despite its WTO accession, and specific WTO commitments with respect to government subsidies, it is truly incredible that the PRC is arguing in the context of our case on coated free sheet paper, that the Commerce Department is legally prohibited from applying the countervailing duty law to imports from China. It is inconceivable to me that China would expect to garner all the benefits from WTO membership and yet argue that it is not bound by the responsibilities that WTO participation carries with respect to subsidies—responsibilities it specifically agreed in 2001 to uphold.

As I noted, Commerce has the legal authority to apply the CVD law to China. But we welcome all efforts to offset subsidies, including legislative efforts by this Committee and the WTO case brought by the U.S. Trade Representative. The USTR has requested consultations regarding nine subsidy programs in China that are prohibited under WTO rules. NewPage believes that Chinese paper exporters benefit from several of these subsidies, which we alleged in our countervailing duty petition.

I would urge the members of this Committee to help ensure a level playing field by making clear to the Department of Commerce, and to the People’s Republic of China, that the countervailing duty law does, in fact, apply to China. I thank you for your attention and would be pleased to answer any questions.

Chairman LEVIN. Thank you so much.
Dr. Navarro.

STATEMENT OF PETER NAVARRO, PH.D., PROFESSOR, UNIVERSITY OF CALIFORNIA, IRVINE, THE PAUL MERAGE SCHOOL OF BUSINESS, IRVINE, CALIFORNIA

Mr. NAVARRO. Thank you for the invitation. My message to you today is a simple one. The Administration has underestimated the scope of the China problem and overestimated its ability to solve it. The ball is in Congress’s court.

What I would like to do for you today is answer the question: What do you do? I think the policy framework I have offered in my table in the written testimony which is projected on your screen gives you an idea of the scope of this problem and a policy framework. Let me walk through this real quickly.

The first category is subsidies and tax preferences, which the gentlemen have been talking about. These include things like subsidized energy, water, telecommunications, free land, free capital, value-added tax rebates. The important point to grasp here is that even if the Trade Representative was wildly successful in their recent complaints, it is only 17 percent of the problem.

The same problem is with currency manipulation. This was a subject, for example, of the Schumer-Gramm legislation that was put before you. Unfortunately, the media perception was that some-

how was a magic bullet to the problem. When you net out the import content, it is only 11 percent. It needs to be done, currency reform, but it is not the magic solution.

The third problem was the subject of the first panel. Let me say this: The first panel did not mention, I think, the most important point regarding piracy and counterfeiting. It is not just about the fact that American movie companies can't sell their movies in China because they are copyrighted. It is the fact that counterfeiters and pirates get real cost advantages relative to us here in America.

They don't have to pay R&D; that hurts the auto manufacturers and the pharmaceutical companies. They don't have to pay marketing expenses for branding. Look, wouldn't we all in America love not to have to pay Microsoft and Oracle and SAP for our software needs? That is a critical point that needs to be grasped.

Lax health and safety regulations, as well as lax environmental regulations: China is the most dangerous place to work in the world. It is the dirtiest country in the world. The problem here is that these lax standards provide real cost advantages to Chinese manufacturers. They don't have to worry about dumping toxic chemicals in rivers. They don't have to put scrubbers on their power plants. They don't have to train their people. They don't put filters in their factories. The result is a real cost advantage.

The sixth and seventh what I call the drivers of the "China price" are in the category of what I refer to as mixed mercantilism rather than pure mercantilism. We have got both labor costs and foreign direct investments here.

Labor, look, China has a comparative advantage in labor. There is no question about it, but to the extent that they don't have adequate health and safety regulations, that is an issue. To the extent that they use slave labor, that is an issue. They have contracts which are effectively indentured servitude. They do not enforce the minimum wage which they have on the books. These all factor into their labor advantage and it hurts American workers.

The last thing here is foreign direct investment. Foreign direct investment is running at over \$60 billion a year right now in China, and going up to 100 billion. When you have FDI, you have got tremendous technology transfer, and you have got tremendous acceleration of best management practices. You wed that to a cheap labor force, and that is a powerful driver. That is a comparative advantage they have.

Yet there still are mercantilist elements associated with that. For example, 20 to 30 percent of the so-called foreign direct investment in China is really attributable to what they call the "round tripping" of capital. It comes from China, out through Hong Kong, and it comes right back. It is attracted by a variety of subsidies and tax preferences, which violate the WTO, which are unfair trading practices, and which partially account for their advantage there.

The point I am trying to make here is simply that if you are going to do a good job of addressing the China problem, you are going to need to take an omnibus approach. You can't do this in a piecemeal fashion. You can't let the trade rep to subsidies. You can't do just a bill on piracy. You can't pass just a bill on currency

manipulation because it is all these things. These folks here who are trying to run companies are dying by a thousand cuts.

So I would hope that the Congress would approach this in a fashion. I do not believe that the Administration is capable of handling this. They are distressed by other events, and plus watching particularly the Treasury Secretary in his fruitless efforts to bring China to the bargaining table has been very discouraging.

So, I salute you, gentlemen and ladies, for having this here today. I would be happy to answer any of your questions, but please, this is a problem that we need to confront head-on.

[The prepared statement of Mr. Navarro follows:]

Statement of Peter Navarro, Ph.D., Professor, University of California, Irvine, The Paul Merage School of Business, Irvine, California

Mr. Chairman and members of the Subcommittee. My name is Peter Navarro, and I want to thank the members and staff of this subcommittee for the opportunity to testify today on the crucial issue of U.S.-China trade relations—specifically the role of a complex web of mercantilist export subsidies in providing China with an unfair competitive advantage over U.S. manufacturers.

As a biographical note, I am a business professor at the University of California-Irvine and hold a PhD in economics from Harvard University. My research has appeared in academic journals ranging from the *Journal of Economic Perspectives*, the *Journal of Business*, and the *Rand Journal* to the *Harvard Business Review* and *China Perspectives*. I am also the author of a number of books on economics and public policy, including *The Coming China Wars: Where They Will Be Fought, How They Can Be Won* (Financial Times, 2006).

My value-added in this proceeding will be to provide members with a conceptual framework with which to understand the broad scope of Chinese mercantilist practices as well as to provide a more expansive definition of what constitutes an unfair “mercantilist export subsidy.”

In this testimony, I will identify the eight major drivers of the so-called “China Price,” which is a short hand term for Chinese competitive advantage in world markets. Most importantly, I will illustrate how fully 7 of these 8 China Price drivers are, in turn, driven by a complex web of direct, indirect, and hidden mercantilist export subsidies.

I shall conclude this testimony by urging Congressional policymakers not to compartmentalize the various factors contributing to China’s unfair trade practices nor deal with them in piecemeal policy fashion. Instead, I urge Congressional leaders to address Chinese mercantilism in a comprehensive and integrated fashion that hits all mercantilist points of the China Price compass. The framework offered in this testimony may be helpful in the policy architecture and design.

China’s Clear and Present Danger to America

By practicing a highly evolved form of 18th century “beggar thy neighbor” mercantilism, China is emerging as a 21st century economic superpower. While consumers around the world have benefited from the flood of cheap goods, China’s broad portfolio of unfair trade practices has resulted in the loss of millions of jobs in countries ranging from the United States and Mexico to Brazil and Lesotho. Chinese mercantilism is also depressing wage and income levels worldwide while China’s exploitation of lax environmental and health and safety standards as competitive drivers is killing millions of Chinese workers and citizens and generating significant regional and global pollution.

To understand both the breadth and depth of Chinese mercantilism and its far ranging effects, it is essential to first understand the mercantilist roots of the so-called “China Price” and the complex web of direct, indirect, and hidden export subsidies that have so sharply honed China’s global competitive advantage. The China Price refers to the ability of Chinese manufacturers to undercut global competitors by as much as 50% or more over a wide range of manufactured goods. Today, as a result of this powerful “weapon of mass production,” China has emerged as the world’s blue collar “factory floor.”

The rapidity with which China has captured a wide range of markets is breathtaking: Already, China controls over 70% of the world’s market share for DVDs and toys, more than half of the share for bikes, cameras, shoes, and telephones; and more than a third for air conditioners, color TVs, computer monitors, luggage, and microwave ovens. It has established dominant market positions in everything from

furniture, refrigerators and washing machines to jeans and underwear (yes, boxers and briefs). As it moves inexorably up the value chain, China is now even making rapid inroads into the global auto market.

In wielding the China Price to capture these markets, China has all but gutted many segments of blue collar manufacturing in countries around the world. In this regard, it's one thing for America to lose much of its blue collar manufacturing base to China. If the U.S. loses its white collar science and technology base too, it will be Americans living the peasant life rather than the Chinese.

Alarming, under the catalyst of Chinese mercantilism, the shift of America's white collar science base has already begun. For example, the American biotech and pharmaceutical industries are already well on their way to offshoring much of their research and development and production to China. Indeed, today, there are more than 300 biotech companies in China, and nearly every major pharmaceutical company has built, or is building, a research center in China.

An Expanded Definition of "Export Subsidy"

Given current trends, it is crucial that U.S. policy makers cultivate a much more sophisticated understanding of the phenomenon of the China Price—as well as its mercantilist foundation and roots. In cultivating this understanding, it is equally essential for U.S. policymakers to use a broad definition of what truly constitutes an unfair "mercantilist export subsidy." The clear danger of using an overly narrow definition is that policymakers will compartmentalize various aspects of Chinese mercantilism, e.g., currency manipulation, IP protection, and then attempt to deal with these issues legislatively in a piecemeal fashion.

In this regard, while there are various legal and technical definitions for what constitutes an illegal or prohibited export subsidy in forums like the GATT and the WTO, the most useful economic definition for policymaking purposes is an expansive definition of a mercantilist export subsidy that includes *any direct or indirect government action or inaction that unfairly stimulates export activity at the expense of trading partners*.

For example, a direct government action would be the use of tax rebates for exporters while an indirect action would be currency manipulation, which is designed to undervalue a country's exchange rate and thereby gain competitive advantage. More subtly, a government *inaction* would be the sanctioning of counterfeiting and piracy despite laws established to prevent such practices. Each of these direct and indirect government actions and inactions may be thought of most broadly as "mercantilist export subsidies" because their intent is to encourage the country's export trade in ways which are clearly outside the bounds of free and fair trade.

The table on the next page provides an overview of the eight major drivers of the China Price and the various direct, indirect, or hidden mercantilist export subsidies used by China to capture markets in world trade. This table is based on a research project I conducted with a large team of MBA students over a year long period at the University of California-Irvine (Download *The Report of the China Price Project* at www.peternavarro.com). The purpose of that project was to answer these two questions: What are the major sources of Chinese competitive advantage in world markets and to what extent is Chinese competitiveness driven by fair versus unfair trading practices.

Column One of the table on the next page identifies the various "Pure Mercantilism" and "Mixed Mercantilism" drivers of the China Price while Column Two indicates their relative importance in the China Price equation. The third column may be of most interest to this subcommittee. It identifies the array of mercantilist export subsidies associated with each China Price driver.

Economic Drivers of the "China Price" & Their Mercantilist Elements		
PURE MERCANTILISM	Share	DIRECT, INDIRECT, OR HIDDEN EXPORT SUBSIDY
1. Subsidies & Tax Preferences	17%	<ul style="list-style-type: none"> • Subsidized energy, water, & telecommunications • Free or subsidized land or rent & preferential land access • Free or subsidized capital, loan forgiveness, preferential loans • Tax rebates for exporters
2. Currency Manipulation	11%	<ul style="list-style-type: none"> • Exchange rate distortion: "Exports cheap, imports dear" • Export demand stimulant via interest & mortgage rate effects
3. Piracy & Counterfeiting	9%	<ul style="list-style-type: none"> • Reduced IT costs • Reduced R&D & Marketing Costs
4. Lax Health & Safety Regulations & Enforcement	2.5%	<ul style="list-style-type: none"> • Reduced compliance costs (capital, O&M, labor) • Lower compensation & liability costs
5. Lax Environmental Regulations	2.5%	<ul style="list-style-type: none"> • Reduced compliance costs (capital, O&M, labor)
Subtotal	42%	
MIXED MERCANTILISM		
Foreign Direct Investment	3%	<ul style="list-style-type: none"> • Attracted by lax health & safety and environmental standards • "Round Tripping" of capital = lower production costs
Low Labor Costs	39%	<ul style="list-style-type: none"> • "Slave labor", indentured servitude, & union-busting • Non-enforcement of minimum wage • Lax health & safety standards
Subtotal	42%	
Grand Total	82%	

Source: Peter Navarro, Report of the China Price Project, UC-Irvine, July, 2006. Download at www.peternavarro.com

The first five China Price drivers represent a very pure form of Chinese mercantilism and account for over 40% of China's competitive advantage. These drivers include a pervasive system of subsidies and tax preferences designed to stimulate the export economy, currency manipulation which distorts the dollar-yuan exchange rate relative to market forces, government-sanctioned counterfeiting and piracy, and a set of lax, and laxly enforced, environmental and health and safety regulations that fall far short of international norms and standards.

The sixth and seventh Chinese Price drivers are Foreign Direct Investment and Low Labor Costs. These drivers may be characterized as "Mixed Mercantilism" because of various mercantilist elements which enhance what would otherwise be a fair comparative advantage. (The final driver, not pictured in the table, is a very sophisticated form of industrial network clustering. See Report of the China Price Project for details, www.peternavarro.com.)

China Price Driver #1: Subsidies, Tax Preferences, and Other WTO Violations

Under state control, many Chinese state-owned manufacturers are operating with the benefit of state-sponsored subsidies, including: rent, utilities, raw materials, transportation, and telecommunications services. That is not how we define a level playing field.

Former U.S. Department of Commerce Secretary Donald Evans

The first China Price driver encompasses a wide, but often difficult to detect, array of mercantilist subsidies and tax preferences that provide Chinese exporters with reduced costs. This array includes subsidized energy and water as well as preferential access to free or cheap land or rent.

Despite alleged reforms, China's state-owned banks also continue to hold a large portfolio of non-performing loans. These NPLs often have been issued in a preferential manner and without expectation of repayment, providing many Chinese enterprises with essentially free money. Despite numerous WTO-related complaints, China also continues to use an extensive tax rebate system for its export industries.

China Price Driver #2: Currency Manipulation

To maintain its undervalued currency—and thereby sell its exports cheap and keep foreign imports dear—China maintains a fixed currency peg between the U.S. dollar and the yuan. To maintain that peg, China must recycle large sums of its surplus U.S. dollars gained in the export trade back into the U.S. bond market. Through such activity, China has become the de facto "central banker" of the U.S., with its net capital inflows roughly equal to that needed to finance the U.S. budget deficit.

Chinese currency manipulation is an indirect export subsidy because it artificially depresses the price of Chinese exports while inflating the price of exports from the U.S. This is not the only effect of Chinese currency manipulation, however.

More subtly, China's massive recycling of its surplus U.S. dollars back into the U.S. bond market has helped keep long term interest rates and mortgage rates artificially low. This, in turn, has helped transform the typical U.S. home into an "ATM machine." Indeed, many Americans have become "serial refinancers" of their homes. By taking equity out of their homes, they have managed to boost their consumption in the short run, and much of what these serial refinancers spend is on cheap Chinese imports. The practical effect has been a short run boost to the economy. Longer term, this is a dangerous situation because it is saddling U.S. consumers with more and more debt and U.S. homeowners with more and more risk of defaulting on their mortgages.

China Price Driver #3: Counterfeiting and Piracy

China is the piracy capital of the world. It accounts for $\frac{2}{3}$ of all the world's pirated and counterfeited goods and fully 80% of all counterfeit goods seized at U.S. borders.

Chinese counterfeiting and piracy help lower production costs for Chinese manufacturers relative to competitors in a number of ways that vary in degree by industry. For example, Chinese counterfeiters don't have to pay for R&D costs. This has been a particular stimulant to sectors like autos and pharmaceuticals. Nor do Chinese pirates who steal software have to pay for IT costs while Chinese counterfeiters save on marketing costs because they don't have to build brand.

Chinese counterfeiting and piracy is a classic example of how government *inaction* leads to a mercantilist export subsidy. Despite highly publicized periodic crackdowns on counterfeiting and piracy by the Chinese government, much of it remains state-sanctioned. Indeed, stripped of Chinese rhetoric, counterfeiting and piracy represent a cornerstone of the country's discretionary macroeconomic policies.

In this regard, it has been estimated that anywhere from 20% to as much as a third of China's GDP is derived from counterfeit and pirate activity. This intellectual property theft generates tens of millions of jobs while keeping prices and inflation low. That's why, absent outside pressure from the U.S. and other members of the global community, China will continue to merely give lip service to IP protection.

China Price Driver #4: Lax Health and Safety Standards

Lax health and safety standards represent an important hidden mercantilist export subsidy. Under China's lax regulatory regime, China has become one of the most dangerous places to work in the world.

The highest risk industries in China include building materials, chemicals, coal production, machinery manufacture, metallurgy, plastics, and textiles. Diseases ranging from silicosis and brown lung to a variety of cancers caused by the ingestion, inhalation, or contact with toxic chemicals and waste are endemic. Workplace injuries are endemic.

The cost advantages to Chinese exporters derived from this lax health and safety regime range from the use of cheaper equipment for workers and fewer safety-related expenses to savings on training and safety-related large capital expenditures. For example, Chinese textile companies are unlikely to invest in anti-noise or dust control equipment. Chinese coal mining companies tend to skimp on masks, goggles, and emergency rescue facilities while a wet drilling system costs as much as 60% more than a dry drilling system but significantly reduces hazardous dust emissions.

In addition, the compensation of Chinese workers who are maimed or dismembered in the production process is often reduced or withheld by companies in China. This callous behavior results in a reduction in liability costs for Chinese exporters relative to global competitors.

China Price Driver #5: Lax Environmental Standards and Enforcement

China's lax environmental regulations and weak enforcement likewise provide Chinese exporters with a hidden mercantilist export subsidy. There is, however, some irony in using the term "hidden" here. China's air and water pollution are highly visible within China—with Beijing, Shanghai, and China's industrial heartland often enveloped in a toxic shroud. Meanwhile, America's air basins are also being despoiled by Chinese "chog," an equally toxic combination of smog, particulate and hazardous substances like mercury, while much of the acid rain falling in both Japan and South Korea is "made in China."

China lax environmental regime provides a variety of cost advantages to its industrial sector. Enterprises save money on protective equipment for workers. Many don't have to invest in pollution control technologies while those that do invest save

money by not operating the equipment. Waste disposal costs are also considerably reduced. The net result is a significant reduction in compliance costs relative to competitors.

China Price Driver #6: Foreign Direct Investment

Among developing nations, China has become the leading destination of Foreign Direct Investment (FDI). Since 1983, FDI has grown from less than \$1 billion a year to over \$60 billion. 72% of China's FDI targets manufacturing.

This China Price driver fits into the category of "Mixed Mercantilism." This is because that while much of FDI is attracted to China because of China's comparative advantage in labor and the promise of a burgeoning new market, FDI is also arriving on China's shores because of various mercantilist aspects of the Chinese economy.

For example, both the aforementioned lax health and safety standards and weak environmental laws and enforcement have helped attract FDI from countries like Japan, South Korea, Taiwan, and the U.S. where standards are much higher. This observation illustrates an undesirable synergy between China's mercantilist policies and the attraction of FDI.

Equally troubling is the pervasive practice of the "round tripping" of Chinese capital. In particular, 20% to 30% of China's FDI is estimated to be of domestic origin. It is the result of the "round tripping" of mainland Chinese capital, primarily through Hong Kong (and also the Virgin Islands). This round tripping of capital is clearly mercantilist in nature and quite contrary to the spirit and tenets of the WTO. This is because it is driven by the special preferences awarded to FDI in the form of lower tax rates, land use rights and subsidies, administrative support, and other subsidies as well as by a desire to evade foreign exchange controls.

China's catalytic FDI provides a variety of competitive benefits. It finances the transfer of the most technologically advanced production and process technologies. It has brought with it managerial best practices and skills as many FDI-financed enterprises are managed by foreign talent. FDI is also often tied to the improvement of both marketing and distribution skills. When all of these attributes are tied to one of the least expensive labor forces in the world, FDI becomes a powerful competitive driver. To the extent that a significant component of FDI is driven by mercantilist elements, it represents a hidden mercantilist export subsidy.

China Price Driver #7: Low Labor Costs

The China Price driver of low labor costs likewise fits into the category of "Mixed Mercantilism." While China has an undeniable comparative advantage in its well-disciplined and well-educated workforce, China's low wage costs are also driven by significant mercantilist elements.

The aforementioned lax health and safety standards represent one such element. In addition, there are the well-known problems of the use of slave labor, the specification of labor contracts in a manner which constitutes indentured servitude, the failure to pay the minimum wages specified under law, and the lack of any right to freely associate or organize into bargaining units or unions. Together, Chinese mercantilism in the workplace provides Chinese exporters with an additional unfair advantage over competitors.

Summary and Conclusions

The picture that emerges from this analysis of the China Price and its economic drivers is that of a picture of a country singularly intent on export-driven growth that uses a complex web of direct, indirect, and hidden mercantilist export subsidies to beggar its neighbors. The policy framework strongly suggested by this China Price-Mercantilist Export Subsidy analysis is one that requires a comprehensive, rather than piecemeal, policy approach.

In particular, rather than deal with each of the various aspects of Chinese mercantilism such as IP protection or currency manipulation or labor abuses with separate pieces of legislation, it may be far more useful to develop an comprehensive, omnibus bill that hits all points of the mercantilist China Price compass. It is to this goal that I urge this subcommittee to direct all possible energies.

Chairman LEVIN. Thank you very much.

Well, there are eight of us, and there may be one or more joining us. We are going to try to finish by 12:30. Why don't we each take 3 minutes. I just want to take one minute, and then maybe Mr.

Herger, but then we will call on those who were not here or able to question the first panel, and then we will come back.

You were chosen on a bipartisan basis. I think Mr. Bassett said it so well: The job of you in the private sector, your job is to compete, and our job in the Government is to create a level playing field; if not a level playing field, totally level, a playable playing field. I believe that the subsidy area is one of the most vivid examples of the failure of the Government and this Administration to do so.

China went into the WTO December 2001. It has been more than 5 years. There were some distinct responsibilities on their part, including to file a subsidy document within the first year. There was a failure to do that and failure to press them to do that in any respect in the WTO, including the annual report that we wrote into the China PNTR bill specifically.

So here we are today with massive subsidization on their part in violation of their two obligations, and a failure to be active. It has been an example of a passive approach, feeling that it will work out, that the market will work out its own problems, don't touch it. I think what you have said is that it is our responsibility to enforce the rules so that the market can work fairly. That hasn't happened.

Mr. Herger.

Mr. HERGER. Thank you very much, Mr. Chairman. I think the point that Chairman Levin made really is right on. We need to be enforcing these rules. I think the big question is, we see China coming from an economy that was maybe early 20th century, trying to move into the 21st Century here within a few years.

So, I think the real question is: How do we get there? How do we get where we do have this access, where we are enforcing the rules? I think that is really what is very important, that in the process, we don't cut off our nose to spite our face, but we make sure we are getting real progress that we are able to—be able to note and be able to chart.

Mr. Vargo, I have a two-part question. You mentioned that U.S. productivity and innovation can outweigh China's labor advantage. I would like you to elaborate, and also focus on China's labor laws. China has been accused of not providing worker rights, e.g. child labor or mandatory prison labor, which is something we can unanimously condemn.

Is that the source of China's advantage? If China adopted and enforced every ILO standard and convention, would it immediately lose its cost and labor advantage?

Mr. VARGO. Mr. Herger, I don't have the answer to that. Certainly, their labor laws are very, very different from ours. You read so many instances of terrible working conditions. The overall wage level is quite low in China.

My point is that that is not the reason why they can sell products in the United States as inexpensively as they are being sold. Even if Chinese labor were free, if the average cost of labor is 10 percent of our product and the cost of transportation from China is 10 percent, that wipes it out.

There are other things going on here, which is why we are concerned about currency and why we are particularly concerned

about subsidies. We do not know what will happen with the elimination of these subsidies. We know they have to get rid of them. They are against our interest. They are against China's obligations.

I think when they get rid of them, we are going to see quite a difference. As I look at these, they can be very, very potent. There are other things I said—intellectual property, currency, and others.

Mr. HERGER. Yes. Anyone else have a comment, like to comment on this?

Mr. NAVARRO. Well, I would just refer you to that table. Labor costs are about 40 percent of the China price advantage. If you were to tighten up everything and kind of have American rules over there, it would not solve the problem. There are always other things going on, and subsidies and currency manipulation are easily as or more important than the issue of labor.

Mr. HERGER. Thank you very much.

Chairman LEVIN. All right. Let's follow our procedure that we outlined. Mr. Reynolds, you will be next, if that is okay. He didn't have a chance the first crack around.

Mr. Reynolds.

Mr. REYNOLDS. Some firms are impatient with the U.S. trade remedies law in context with China because it is expensive to bring many of these cases, and China seems to be such a pervasive subsidizer of the economy. Naturally, the firms would prefer the government to bear the expense of bringing WTO cases to stop subsidization.

What is the difficulty in providing USTR with evidence sufficient to bring WTO cases against a broad swath of subsidies, and not just the ones that are part of the recent China subsidy case? Any of the panel wish to comment on that?

Mr. NAVARRO. Let me say two things about that. First of all is that the WTO rules really overly narrowly define just what a subsidy is. So, the kinds of things that are done, it is difficult to pin it down. It is like trying to nail water to a wall.

The other thing is the issue of Chinese transparency. The fact that they haven't complied since 2001 with the transparency and report portion of that agreement has made it very, very difficult for us to respond. So, those two problems alone make it very difficult.

Mr. VARGO. Could I add to that? What you say is certainly true. These trade cases are expensive. They are lengthy. For our members, particularly our smaller members, it is much more feasible to have WTO cases brought.

It is very difficult for our members—again, especially our smaller members—to go do investigations and see what is going on. So, we, as I noted in my prepared statement, want to see USTR and Commerce investigate these more fully and take a broader range of cases.

We are very pleased that this first case is being brought focusing on prohibited export subsidies, which are, I think, the easiest to prove, but we want more. We also want—even though the cases are expensive, we want companies to have the option of being able to bring the countervailing duty cases. We also want the Administration to use section 421.

Chairman LEVIN. I think Mr. Bassett wanted to say something.

Mr. REYNOLDS. I am sorry, I didn't hear the Chairman.

Chairman LEVIN. What?

Mr. REYNOLDS. I didn't hear you.

Chairman LEVIN. I think Mr. Bassett wanted to comment on that. You shook your head. Mr. Bassett, did you want to comment on that issue?

Mr. BASSETT. I only have one comment. I thoroughly enjoyed listening to the professor give us the percentages of what each of these advantages are. I have never had them before, but I am going to contact him and get this in writing.

I would implore you people to do one thing. He wants you to do everything. If you can't do everything, do something.

Chairman LEVIN. Amen.

Mr. BASSETT. Exchange part of this puzzle is out there. I think so often, if we can't put the puzzle together, nothing happens.

Chairman LEVIN. I thought you would have words of wisdom. No, seriously. I think you sum it up beautifully, if I might say so.

Mr. Blumenauer, Mr. Larson isn't back. Mr. Blumenauer?

Mr. BLUMENAUER. Thank you, Mr. Chairman. Again, I think this panel was extraordinarily helpful in terms of getting at the big picture from a variety of different perspectives. I agree with Mr. Bassett. I thought Dr. Navarro's distinctions of the various areas of advantage suggest why we do need to have a comprehensive approach. I hope that we don't just do something, but that we are able to look at it in a comprehensive fashion.

Mr. Bassett, in response to what you are saying, I think we have an obligation to tell you in the business community, the American companies and their workers, and the Chinese, that we are serious about playing by these rules.

I found compelling the testimony about the non-market exclusion no longer making any sense, if it ever did, and I am hoping we can deal with something in terms of a broader application of the countervailing duties.

I have, I guess, one question. I am listening in terms of what happens with steel and with paper products, wondering if any of these find their way into business activities in the United States that in whole or in part involve investment of taxpayer dollars.

Chairman LEVIN. Mr. Goodish, do you want to say a word about that?

Mr. GOODISH. I guess I am not following the question exactly.

Mr. BLUMENAUER. I am wondering if these products that you are talking about that have been lavishly subsidized, that have not been in full compliance of labor standards and the environment, even for the Chinese themselves, if these products ever find their way into government contracts where they are used for construction, for manufacture, that is in total or in part the result of taxpayer investment.

Mr. GOODISH. I think it would be very difficult for us as the manufacturers to be able to assure you that they do not. When you go to stamping plants and you see coils laying ahead of the line that get stamped into automotive parts or truck parts, I am not sure anyone could guarantee you that none of that steel finds its way into a vehicle that the U.S. Government or the American taxpayers don't buy at some point in time.

There is just such a massive import of goods coming into this country from China that are subsidized that I don't think anyone could guarantee you that.

Mr. TYRONE. As it relates to paper products, I would actually be very surprised if they did not. The reason that would be the case is the countries that we filed the anti-dumping and countervailing duty cases on represent 14 percent of imports. So, it is a very large proportion, and I would be very surprised if they weren't.

Mr. BLUMENAUER. I realize my time is expired, Mr. Chairman, but I would like to explore—I am not interested in a lot of bureaucracy; I am not interested in doing something that is goofy, but it just seems to me that there may be some things that we can do to make it difficult for taxpayer dollars to be used for furniture purchases or paper purchases or metals or whatever that are a result of inappropriate activities from a country around the world.

Chairman LEVIN. It is an interesting point. Interesting.

Mr. BLUMENAUER. Thank you.

Chairman LEVIN. We will try to follow up.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. This is a helpful panel, and as we go through this process looking at what we consider illegal subsidies, discussion of the definition of what is a subsidy is helpful.

Mr. Vargo, he gave an example of an imported pair of pliers, with raw materials costing more than the selling price of the finished product. He used that as an example of a clear and obvious subsidy by the Chinese.

Before the Trade Representative's office acted on such cases, the WTO would likely ask about the evidence of subsidies for case development. I ask Mr. Vargo, and if there are others who would like to comment on this, would you go into further detail?

Why isn't the uneconomically low price of a product sufficient evidence? What more do you need to have to challenge subsidies of Chinese makers of pliers and similar products?

Mr. VARGO. Well, to begin with, many of our companies don't have the resources to have investigators go over and see just why the prices are so low. They have evidence sometimes of invoices offering the products, but that in itself is insufficient information to bring a WTO case. The Commerce Department has not applied the countervailing duty statutes to non-market economies, so that route has not been open to them.

We hope that that door will open. I think at that point we may see additional companies step forward with the information they have and bring cases.

Mr. WELLER. Others want to comment on that question?

Mr. GOODISH. I think it is correct. It is extremely difficult for us to be able to gather the facts on exactly what the manufacturing cost is. You can go to endless research firms that we use, such as World Steel Dynamics or J.P. Morgan, and see from the production costs from a ton of steel, it costs as much if not more to produce that ton of steel in China as what it cost us to produce it in the United States. Yet we are now seeing oil country tubular goods, as an example, coming to the country for as much as \$600 a ton under

what our selling price is, which actually takes it under what our manufacturing cost is.

It is hard for us to believe that. We know what the world market for iron ore is. We know what the world prices for coal and coke are. While they have cheap labor, where we might use a manhour and a half or two manhours in a ton of steel, they are using 10 or 15. So, they really don't have the economic advantage on labor because of the volume of labor that they have in their facilities.

We also know with the limitation that they have on power generation that they are also paying probably 8 to as much as 11 cents for power, which our power costs are raising but they are not in that marketplace. They are in the 5 to 6 cents.

So, we know that it costs them as much to produce steel as it costs us to produce steel. Yet we see their products coming into the marketplace well under what our current market prices are.

Mr. WELLER. Anyone else?

Mr. TYRONE. If I may, it was certainly our observation of the prices being offered by Chinese producers relative to our costs that led us to believe that there was some chance that they were pricing below their costs.

Upon further investigation, we did in fact conclude that based on our analysis, there was very good evidence of that, such that we were able to convince both the International Trade Commission and the Department of Commerce to take on both the anti-dumping cases and the countervailing duty cases.

Commerce has done that preliminarily. They are doing the investigation, and they have said that they are using this case to reexamine their practice of not evaluating countervailing duty on non-market economies.

Mr. WELLER. Thank you, Mr. Chairman.

Chairman LEVIN. Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman.

In your testimony, Mr. Vargo, on page 8 of that testimony you talk about America's trade deficit. Two paragraphs in the middle of that page discuss the relationship between imports and exports and how exports have been reduced. So, it is not simply imports that are affecting this deficit. It is the fact that exports have been reduced significantly. I think this was your point. Let me go back and ask you a question about that.

I am reading the testimony here of Mr. Bassett. Your Chair could have been many industries in the past 20 years who have gone through this particular experience, the fact that just in a short period of time, 3 years, 65 furniture manufacturers had to shut down, 18,000 jobs lost.

Now, that doesn't seem like a lot of jobs, but when you begin to look at one industry after the other, when you particularly look at the manufacturing sector, Mr. Vargo in his testimony admitted to the fact that during that period of time—maybe one more year—we lost 3 million manufacturing jobs in the United States of America.

This is a very serious problem, a very significant problem. Whether we are talking about looking at protecting a property or whether we are looking at subsidies, we need to all address this

and be all on the same page. So, I can appreciate what you are going through.

What happened, Mr. Bassett, to the infrastructure in each of those 65 factories? I am very concerned about the manufacturing infrastructure and apparatus. I am looking at the apparatus. When we lose that apparatus, when we lose the manufacturing mechanisms, when we need to go back and understand the significance of manufacturing in this country, we will not have the wherewithal or the material or the mechanisms or the apparatus to deal with it.

Would you please quickly respond to that? Or am I making much out of nothing?

Mr. BASSETT. You are right on. Well, not only are the jobs we are losing—one of the problems I am having right now is so many of my suppliers have disappeared. They are smaller, so you don't hear about them, but trying to find people to buy from because they have nobody to sell to is one of the main problems we are going to encounter. I hope I don't go out of business because I no longer-I have customers but I don't have suppliers.

I am going to vary just a little bit and I want to tell you gentlemen that one of the things I think that you ought to be very cautious about, I read in the Washington Post yesterday about a hearing that you had yesterday. It included, I think, flowers for Valentine's.

Chairman LEVIN. Chocolate.

Mr. BASSETT. The proposition is that you can buy flowers for Valentine's less expensively today than you ever bought them.

Mr. PASCRELL. That is correct.

Mr. BASSETT. Which probably is true. I can't argue with those facts. If the only premise for trade, gentlemen, is the price cheaper, then we are right on the right track.

Mr. PASCRELL. Well, doesn't it get you nervous, though, when the representative of trade says that to this Committee in response to a particular question? If that is the standard, if that is the overall standard that we need to use and the priority standard, we are in bigger trouble than we thought we were.

Mr. BASSETT. I agree with you. Let me tell you the example I use when people ask for it.

Mr. PASCRELL. Sure.

Mr. BASSETT. I come from a very small Southern town in Southern Virginia. Years ago, when I was a young man, there used to be a lot of bootlegging going on. Now, I want to tell you, it was good liquor. It really was. It was good liquor. It was cheap liquor.

Mr. PASCRELL. I will take your word for it.

Mr. BASSETT. But it was against the law to make it, to own it, or to drink it. It was illegal. The ox that was getting gored was the Federal and State governments. They did something about it because they were losing their business.

The premise here is if price is the only thing that we look at and we don't care how we get there, then we ought to go back and let the bootleggers start up again.

Mr. PASCRELL. Mr. Chairman, can I ask one more quick question?

Chairman LEVIN. Yes. I don't think we wanted to finish on that point.

[Laughter.]

Chairman LEVIN. Though I think it is a very good one.

Mr. PASCARELL. Very illustrative.

Mr. NAVARRO. Can I just make one quick point on this?

Mr. PASCARELL. Yes, sir.

Mr. NAVARRO. There is a lot of focus in blue collar manufacturing and how all those jobs have gone. I come here today to tell you that the same thing is happening now in white collar science-oriented jobs.

Mr. PASCARELL. Absolutely.

Mr. NAVARRO. If we lose those jobs as well, it is going to be us living the peasant life.

Mr. PASCARELL. I agree with you.

Chairman LEVIN. Mr. Pascarell, one other thing. Don't lose the power of Mr. Bassett's last point, though.

Mr. PASCARELL. I will not lose that. Thank you for bringing that up.

Mr. Vargo, back to the question. What is your organization doing to protect the interests of small and medium-sized manufacturers in the threat that they face from China for various reasons? What is your organization doing specifically for the medium-sized, small-sized manufacturers?

Mr. VARGO. Several things. First of all, we are pressing hard to ensure that the rules are followed, particularly in this case in subsidies. We are pressing for some specific changes in Chinese law to get better protection for intellectual property. Believe me, that hurts small companies as well as large companies.

So many of our small companies are exporters, we are also pressing to get foreign trade barriers down. As you know, this is a very open market, and we want other markets to be as open to us in tariffs and in non-tariff barriers as we are to them. So, that is a range of things we are doing.

All of the problems that our small companies face are not trade-related. When you go out and talk with our companies, in fact, the number one problem most of them say is, I can't find the skilled workforce I need. My workforce is retiring. I can't find the new ones.

So, we have a range of problems, and we are working on that one, too. So, thank you for that.

Mr. PASCARELL. Thank you.

Chairman LEVIN. I wasn't going to mention this. We have a minute left before we are supposed to recess.

Mr. Vargo, the Korea FTA is being negotiated. They have a complete wall against industrial products, essentially, an economic iron curtain. I am not sure the NAM has weighed in. We have said to USTR, it is essential in those negotiations that there be a tearing down of those walls over time. For example, in automotive, we can't support reduction in tariffs unless there is assured increase in access to the market, measurably.

I hope you would think about joining in to impress upon USTR that, secondly, we had an interesting panel on currency a couple days ago. It was informal, Republicans, Democrats, sitting around

with four experts. If I might ask, take another look in terms of China.

Mr. VARGO. Mr. Levin, could I just quickly respond? We have been pressing hard for a free trade agreement with Korea, not because of tariffs but because of the non-tariff barriers. This will be the first trade agreement the importance of which is in getting non-tariff barriers down. That doesn't happen, then the agreement just does not provide what we want.

Chairman LEVIN. It has to be measurable. We have to find a way to tie their benefit from reduced tariffs to our access in a measurable way. That is the outstanding issue on that part of it. There are other issues in Korea. Some of us have said firmly to USTR, find a way to do that or we won't support the Korea FTA.

All right. We are going to stand in recess until 1:00. You have been an outstanding panel. Thank you very much.

[Whereupon, at 12:29 p.m., the Subcommittee recessed, to reconvene at 1:00 p.m., the same day.]

Chairman LEVIN. Well, maybe we'll begin. We had this break for lunch. It's always dangerous, but we welcome you as the Deputy USTR, Mr. Bhatia, and we did want to try to this time reverse what has been the traditional order and have panels come first so that USTR would have the panoply, the full range of, at least a substantial range of points of view that you could take into account.

Again, Mr. Herger and I welcome you. You have some written testimony, and I'll, since it was provided in advance, I'll assume that all of the members have had a chance to read it.

Not to limit your use of it, but to indicate that we'll put it into the record. Why don't you just set forth in any way that is most you think useful, informative and you can take not hours, but don't worry about the green light, and just give us the view of USTR, taking into account what you heard or were told about in the morning, which I think was very productive. I think Mr. Herger would agree.

Now I had some opening remarks. I won't repeat them, and I think, Mr. Herger, is it all right? Should we just go into—

Mr. HERGER. Why don't we go into it?

Chairman LEVIN. Okay. So, we welcome formally, more officially, the USTR, Trade Representative Karan Bhatia. Welcome.

THE HONORABLE KARAN K. BHATIA, DEPUTY U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. BHATIA. Thank you very much, Chairman Levin, Ranking Member Herger. Let me start by noting that I'm really delighted to be able to be here today to participate in what I understand is the first of a series of hearings that you're going to be conducting on U.S.-China trade relations. I am the Deputy U.S. Trade Representative with principal responsibility for Asia and Africa at USTR. I can tell you that there are few subjects that I spend more time on or that are more complex, more challenging or more important, frankly, than our relationship with China. I truly am very pleased that the Subcommittee is devoting time to this subject today.

I appreciate you taking cognizance of my written testimony, and I won't repeat it, certainly not in its entirety. I thought it might be helpful, though, given that this is the first of a series of hearings, to put in context the specific focus that I know is the focus of today's hearing, namely, subsidies and IPR, perhaps into a little broader context. So if I can, perhaps let me spend a few minutes providing a brief overview of the U.S.-China trade relationship generally, and developments in that relationship in the last 12 months.

Any summary of our interaction with China, of our trade policy with China over the last 12 months I think has to start with our top-to-bottom review of U.S.-China trade relations, which we issued actually a year ago yesterday, so this is a very timely hearing.

That review, which was a comprehensive, interagency overview of U.S.-China trade relations, observed that the policy of economic engagement that we have pursued with China over the past 25 years, I would note it has been a policy pursued largely on a bipartisan basis, across Administrations, has benefited both countries, both United States and China.

The review noted that after a period in which U.S. trade policy was largely focused on bringing China into the international trading system, that relationship is now entering a new phase, one in which China will be held fully accountable for its WTO obligations as a mature trading partner, and will be expected to play a greater role in strengthening the global trading system commensurate with its economic heft and the economic benefit it receives.

The review suggested that as we enter this new period, it is appropriate to revisit U.S. trade policy and in fact to readjust U.S. trade policy and priorities with respect to China, and to do so in favor of enhanced use of enforcement tools and more focused, coordinated and senior level dialog.

Now the top-to-bottom review set forward a number of key objectives. I will tick off a few. First, strengthening the focus on China's WTO compliance and adherence to international norms. Secondly, ensuring that the bilateral trade relationship offers more balanced opportunities and is equitable and durable. Third, a focus on making U.S. trade policymaking with respect to China more proactive and informed by more comprehensive information and more coordination. Fourth, encouraging China to participate more fully in the global trading system, and fifth, ensuring that the United States remains an active and influential player and trading partner in the Asia Pacific region generally. The review set forward a pretty detailed list of steps to achieve those objectives.

Looking back over the past year, I am pleased to report that after we've had the opportunity to consult with Congress, we moved forward full steam to implement the recommendations laid out in the top-to-bottom review, and my written testimony details those steps. Let me just touch on a couple orally here.

First, we demonstrated I think very clearly our willingness to use WTO dispute settlement to hold China to its commitments where necessary. We filed WTO cases on China's treatment of imported parts. We filed another case recently on its use of prohibited subsidies, and we were on the verge of filing a third case last year challenging China's anti-dumping order against U.S. exports of

Kraft Linerboard when China rescinded that order just hours before our filing.

In April, we held a meeting of our Joint Commission on Commerce and Trade, our principal trade dialog with China, at which we obtained Chinese commitments to address a number of concerns about access to China's market, transparency and enforcement of IPR.

We have launched a new and unprecedented provincial level review of China's IPR enforcement efforts and look forward to publishing the results later this spring.

We have held 61 meetings or briefings with Congress over the past year on the subject of our China trade relationship, and consult regularly on such topics as our WTO litigation strategy, the Joint Commission on Commerce and Trade (JCCT) dialog and the newly launched strategic economic dialog, thereby I think strengthening the coordination among different branches of Government that is important in dealing with China.

We have established new channels of communication with our third country trading partners to coordinate trade policy with respect to China. At USTR itself over the past year, we have substantially bulked up our China-focused resources with the creation of the position of the Chief Counsel for China Trade Enforcement, the creation of a China Enforcement Task Force, the addition of new staff in our China office, and the hiring of a new USTR attache in Beijing.

These and many other actions I think that we have taken to implement the top-to-bottom strategy over the past year demonstrate to U.S. stakeholders, to China and to our other trading partners that we do have a carefully crafted strategy for how to engage China on trade matters, and that we have been following it.

Now, Chairman Levin, Ranking Member Herger, I would be the first to say that both the top-to-bottom review and the actions taken to implement it are a means to an end. They are not an end in itself. The end is a trade relationship with China that is more balanced and the opportunities it offers more equitable and more durable. Such a relationship is not going to be achieved within the span of 12 months, but I am pleased to say that there are some encouraging signs, and let me point to three if I may.

First, based on the results just reported by the Commerce Department, U.S. exports to China last year climbed by 32 percent. This suggests that the Chinese market is become more accessible to U.S. companies and that Chinese consumers are developing an appetite for America's highly competitive goods and services.

China today has become our fourth largest export market and the fastest growing major export market for the United States in the world. China is helping to support thousands of American jobs today and will support even more in the future.

Secondly, in its 2006 annual survey of members, the U.S.-China Business Council reported that 81 percent of its members surveyed report that their Chinese operations are profitable, and 97 percent of respondents say they are optimistic about prospects for their China business over the next 5 years.

Third, I would point to the fact that there have been a number of important specific transactions opening the Chinese market to

U.S. companies in the past year, including the acquisition of a stake in Guangdong Development Bank by Citibank, the selection of Westinghouse for a five to eight billion dollar nuclear power contract, and the signing of over 100 purchase agreements and contracts worth over \$16 billion last year in advance of President Hu Jintao's visit to the United States

Now importantly, in citing these developments, I do not mean to suggest that all is well in the U.S.-China economic relationship. Significant challenges do remain. In particular, as we detailed in a 2006 report to Congress on China's WTO compliance that we issued last December, we are concerned by signs that China could seek to slow down or pull back from the market-oriented and WTO-consistent changes that they have been making in their economy and instead pursue more State interventionist or mercantilistic policies.

A retreat from continued reform I believe would slow China's own economic development, dampen U.S. export growth, preclude the leveling of imbalances and breed frustrations. So, working to ensure that China does not slow down or retreat from reform is a key objective.

Mr. Chairman, if I may just in conclusion have a brief note on the two subjects that I know have been occupying your thoughts and attention this morning, subsidies and IPR.

Chairman LEVIN. Take your time. Take your time.

Mr. BHATIA. Thank you. On subsidies and IPR, these are two clearly critical topics. They are two topics that perhaps pose some of the greatest challenges to U.S. trade policy and to our engagement with China.

I would point out I think that both are being addressed consistent with—that we are seeking to address both consistent with the template we laid out in the top-to-bottom review. On subsidies, and on IPR, we have pursued both enforcement and dialog. Both are serious concerns for the United States. Both are serious concerns for our other trading partners, and both should be serious concerns for China.

On both IPR and the use of government subsidies that distort trade and the global economy, China has at the most senior level said the right things, but that is not enough. We need to see changes in results on the ground, and we have made that clear to China.

On subsidies, we have, as you know, filed a WTO case. On IPR, we have made very clear that we are prepared to do so. At the same time, we are pursuing focused and forceful dialog I think in both areas to try to make progress consistent with our goals outside of litigation, and we will continue to do both.

I have more detailed remarks on both subject, Mr. Chairman, in the written testimony. I'm happy to elaborate on those areas further, but I think perhaps let me stop here and I'd be happy to respond to any questions that you or others would have.

[The prepared statement of Mr. Bhatia follows:]

Statement of The Honorable Karan K. Bhatia, Deputy U.S. Trade Representative, Office of the U.S. Trade Representative

Introduction

Chairman Levin, Ranking Member Herger and distinguished members of the Ways and Means Subcommittee on Trade, I am delighted to be able to participate in the first of what I understand is to be a series of hearings on U.S.-China trade relations. As the Deputy U.S. Trade Representative with principal responsibility for our Asian and African trade relationships, I can tell you that there are few subjects that I deal with that are more important or more complex than our relationship with China, and I'm very pleased that this subcommittee is devoting time to this subject.

I understand that today's hearing is focused principally on two topics: (i) subsidies and (ii) the enforcement of intellectual property rights. I will touch on both subjects. But, especially because this is the first of a number of hearings that the Subcommittee intends to conduct, I thought it might be helpful to provide a brief overview of the U.S.-China trade relationship generally and developments in that relationship over the past 12 months.

Top-to-Bottom Review

One year ago yesterday, USTR issued a comprehensive, interagency "Top-to-Bottom Review" ("T2B" or "Review") of U.S.-China trade relations. That Review observed the policy of economic engagement the U.S. has pursued with China for the past 25 years—on a largely bipartisan basis across administrations—has benefited both countries. The Review also noted that, after a period in which U.S. trade policy was largely focused on bringing China into the international trading system and urging China to implement its new WTO commitments during a transition period, the relationship is now entering an important new phase—one in which China will be held fully accountable for its WTO obligations as a mature trading partner and will be expected to play a greater role in strengthening the global trading system commensurate with its economic heft and the economic benefits it receives. The Review urged, as we enter this new period, the readjustment of U.S. trade resources and priorities with respect to China—in favor of enhanced use of enforcement tools and more focused, coordinated and senior-level dialogue.

The T2B set forth a number of key objectives: (i) strengthening the focus on China's WTO compliance and adherence to international norms, (ii) ensuring that the bilateral trade relationship offers more balanced opportunities and is equitable and durable, (iii) making U.S. trade policymaking more proactive and informed by more comprehensive information and more coordination, (iv) encouraging China to participate more fully in the global trading system, and (v) ensuring that the United States remains an active and influential economic and trading power in the Asia Pacific region. The T2B also set forth a detailed list of steps to achieve those objectives.

Top-to-Bottom Review—Implementation

Looking back over the past year, I am pleased to report that, after the opportunity to consult with Congress, we have moved full-steam ahead to implement the recommendations laid out in the T2B. Let me run through a few:

- We demonstrated our willingness to use WTO dispute settlement to hold China to its commitments. Under Ambassadors Portman and Schwab, we filed WTO cases on China's discriminatory treatment of imported auto parts and use of prohibited subsidies. And we were on the verge of filing a third case last year, challenging China's antidumping order against U.S. exports of Kraft Linerboard, when China rescinded that order just hours before our filing.
- In April 2006, we held a meeting of the Joint Commission on Commerce and Trade (JCCT). At that meeting, we obtained Chinese commitments to address a number of concerns about access to China's market, transparency, and enforcement of intellectual property rights. President Bush also had an opportunity to discuss important economic issues with President Hu Jintao during his visit to the United States.
- In September, President Bush launched a new high-level dialogue to address critical economic issues—the Strategic Economic Dialogue (SED). The first SED meeting was held in Beijing in December, and we have been pushing forward with a number of specific follow-up discussions in anticipation of the next SED meeting here in May. To further bolster the initiative, Secretary Paulson recently announced that Treasury has appointed Ambassador Alan Holmer as Special Envoy to China overseeing the SED process.

- We have launched a new and unprecedented provincial level review of China's IPR enforcement efforts, and look forward to publishing the results later this Spring.
- We have held dozens of sector—or issue-specific negotiations with the Chinese in areas ranging from beef to telecommunications, as we seek to ensure that China continues to open its markets and honor its commitments.
- We have held 61 meetings or briefings with Congress over the past year regarding our China trade relationship and have regularly consulted on such topics as our WTO litigation strategy, the JCCT dialogue, and the SED.
- We have created a senior-level China Task Force within our Advisory Committee on Trade Policy and Negotiations.
- We have established new channels of communication with our third country trading partners to coordinate trade policy with respect to China.
- And at USTR, over the past year, we have substantially strengthened our China-focused resources, with the creation of the position of Chief Counsel for China Trade Enforcement, the creation of a China Enforcement Task Force, the addition of new staff in our China Office, and the hiring of a new USTR attaché in Beijing.

These and the many other actions we have taken to implement the T2B strategy over the past year have been important, both individually and collectively. They demonstrate to U.S. stakeholders, to China, and to our other trading partners that we have a carefully crafted strategy for engaging China on trade matters, and that we have been following it.

Of course, both the T2B and the actions taken to implement it are means to an end, not an end in itself. The end is a trade relationship with China that is more balanced in the opportunities it offers, more equitable and more durable. Such a relationship will not be achieved within the span of a mere 12 months. But I am pleased to say that there *are* some encouraging signs. Let me point to three:

- Based on the results just reported by the Commerce Department, U.S. exports to China last year climbed by 32 percent. (By contrast, I would note that China's exports to the U.S. increased by 18 percent.) This suggests that the Chinese market is becoming more accessible for American companies, and that Chinese consumers are developing an appetite for America's highly competitive goods and services. China today has become our fourth largest export market, and the fastest growing major export market for the United States in the world. It is helping to support thousands of American jobs today and will support even more in the future.
- In its 2006 annual survey of members, the U.S.-China Business Council reported that 81 percent of members surveyed reported that their Chinese operations are profitable (with more than half saying that profitability rates for their China operations meet or exceed global profit margins) and 97 percent of respondents saying that they are optimistic about prospects for their China business over the next five years.
- There have been a number of important transactions that have helped to further open the Chinese market to U.S. companies—including the acquisition of a stake in Guangdong Development Bank by Citibank, the selection of Westinghouse for a \$5–8 billion nuclear power contract, and the signing of over 100 purchase agreements and contracts worth over \$16 billion in advance of President Hu Jintao's visit to the United States last April.

In citing these positive developments, I do not mean to suggest that all is well in the U.S.-China economic relationship. Significant challenges remain. In particular, as detailed in the 2006 Report to Congress on China's WTO compliance that USTR issued last December, we are concerned by signs that China could seek to slow down or pull back from the market-oriented and WTO-consistent changes they have been making in their economy and pursue more state interventionist or mercantilist policies. A retreat from continued reform would slow China's own economic development, dampen U.S. export growth, preclude the leveling of imbalances, and breed frustrations. So, working to ensure that China does not slow down or retreat from reform is a key objective.

Let me now turn to the two specific topics at issue here today—subsidies and IPR—and briefly discuss the most recent developments in our dealings with the China on these two topics.

Subsidies

In testimony last year before the Senate Finance Committee, I observed that the Chinese Government's role in directing the Chinese economy, including through the use of subsidies, was one of the principal concerns of USTR. The way we have approached this issue over the past twelve months is entirely consistent with the

strategy laid out in the T2B—we are confronting this serious challenge using both enforcement levers as well as dialogue.

As you know, just two weeks ago we announced that the United States has requested consultations at the WTO over what we contend is China's persistent use of prohibited subsidies. Basically, the United States believes that China uses its tax laws and other tools to encourage exports and to discriminate against imports of a variety of manufactured goods. The subsidies at issue in this case are offered across a broad array of industry sectors in China—including steel, wood products, information technology, and others.

It is an important case—important because it challenges policies that are tilting the playing field against our workers and companies, important because it makes clear that we will use WTO dispute settlement procedures to hold China to its commitments where dialogue does not resolve our concerns, and—perhaps most of all—important because it will help impel China to maintain a process of reform and to redirect its economy towards a model of consumption-led, rather than export-led, growth.

While we have filed this WTO case, we continue to engage in dialogue with the Chinese on their use of subsidies. These discussions are happening both at the sector-specific level—for example, our recently created “Steel Dialogue” under the JCCT is enabling a conversation among governments and industries of both sides—as well as in connection with our broader economic dialogues, including the Strategic Economic Dialogue. Industrial policies that limit market access for non-Chinese origin goods and that provide substantial government resources to support Chinese industries also remain a concern.

Finally, although it does not fall within USTR's statutory purview, I should note that the Department of Commerce continues to apply U.S. trade remedy laws to ensure that unfair trade practices, whether undertaken by the Chinese or others, do not distort the playing field against U.S. companies.

IPR Enforcement

The Administration is similarly employing a dual-track approach in the area of intellectual property rights. The rampant infringement of intellectual property rights that persists in China, in spite of efforts by central government officials to move against illegal practices, not only robs U.S. businesses of billions of dollars a year in legitimate sales, it also weakens China's development of its own knowledge-based industries.

Over the past year, we have been working to prepare a WTO case that challenges China's compliance with its WTO obligations in the area of intellectual property rights enforcement. Last October, we informed China that we would be filing such a case, but then agreed to hold off, with the support of U.S. industry, when China asked for further bilateral discussion. We have been holding those discussions, including late last month in Beijing. We have also been raising with China restrictions on market access. While these are not IPR issues per se, they have a negative impact on the industries depending on intellectual property, such as the copyright industry and, to a certain extent, they exacerbate some of the problems with IPR enforcement. Thus far, no settlement has been reached. We are consulting with Congress and with industry on next steps. If we believe that negotiations offer a reasonable chance of success, we will continue to pursue them—a successfully negotiated outcome can be more efficient and as successful as a litigated outcome. But if it becomes clear that negotiations will not be successful, then we will proceed with WTO dispute settlement.

In the interim, of course, we continue to try to work with China through various other avenues to address this serious problem. For example, under Special 301, we are conducting a special review of enforcement at the provincial and municipal levels of government where much of the responsibility for day-to-day enforcement lies. We are also continuing to press China to make improvements in its IP system through the JCCT and SED.

It bears noting that at the highest levels of the Chinese government there is a clearly stated commitment to tackle this problem. In his remarks from the South Lawn of the White House in April, President Hu affirmed that China is committed to “strengthening the protection of intellectual property rights.” China's leadership appears to recognize that the development of a more vigorous and effective IPR enforcement system is critical not only to trade relations with the United States, but also to China's own economic development. The challenge confronting China is turning those stated commitments into real results.

Thank you for the opportunity to testify. I will be happy to take your questions.

Chairman LEVIN. Thank you very, very much. So, let's have a good back-and-forth for a few minutes.

Mr. BHATIA. Great.

Chairman LEVIN. Others may join us, but with Mr. Herger and myself, this is an important gathering in our eyes. Let me just repeat what I said both on the record here and in talking to others in the media.

I welcome the fact there's been this bottom-to-top or top-to-bottom review, number one. It was long overdue. As I look back since we had the controversial discussion of PNTR, which I was very much involved in, the first years were really years of very passive reaction. It was very disappointing. This is before you came. I think it was harmful.

China went in with the assumption that it was much better for it to be in than out, not only for them, but it would be better for us, that there would be rules that they would need to comply with. The problem is that while in some respects the structure opened up their markets, there were so many requirements that they failed to meet. We have this morning discussed two of the areas, subsidies and IPR.

I don't think anybody can say that there was much more than rhetoric. Essentially, there was a passive attitude, and that was true of our position, this Administration's position within the WTO, whether it was the annual review program that we fought to get into the PNTR legislation, pursuing the requirement that they file their subsidy report. So, I do think it's good that we have shifted out of what might be called neutral in terms of a car, the car I used to drive when I was young, into first. It's now kind of different.

We really need to accelerate our attention to this, and that's why we talked this morning about setting 2008 when the Olympics will be in Beijing, for China to take a kind of leap in terms of their compliance with their commitments.

You mentioned, Mr. Bhatia, the exports. I said this to USTR, to your boss yesterday, our ambassador. Also talk about imports. You talk about the percentage of increase in our exports. It starts from such a low base. As you know, the amount of our imports far exceed the amount of our exports. So you have a continuing increase in our trade deficit. I just wanted to bring your attention to an example of I think the harmful failure of this Administration before your time.

We put 421 in there. It was part, as we said, at this very place, it was part of what we worked out. We did so on a bipartisan basis with a lot of controversy. The Administration has failed to use it. I give you one example of the harm of this failure. It relates to pipes and tubes from China. A case was—it was filed. The ITC found harm. The Administration decided not to take action, and in terms of thousands of net tons, which happened since 2004 when it was 274, it's now 671 thousands. That's more than doubling.

You have to look at this in terms of the impact on businesses and workers here. I know it means that some people bought pipe more cheaply, but businesses and workers have been displaced. So, try to carry back the message. Talk about the whole glass.

Secondly—and by the way, I have the figures here in terms of the exports and imports, and it's really clear, exports rose by 13.3 billion '05 to '06, imports rose by 44 billion. So, if you start with a low base, you'll get a higher percentage. That's about as much as I learned in math.

All right, but now let's talk about subsidies, and then Mr. Herger will take over. A long last, China filed its subsidies report, right? Three or 4 years late.

Mr. BHATIA. Yes, that's right.

Chairman LEVIN. Okay. Now they identified 70, and that's only a partial report, 70 subsidy programs, and they're probably just the tip of the iceberg. Your notice, what you started with, touches how many of these?

Mr. BHATIA. The case that we have—the consultations?

Chairman LEVIN. Right. It's not a case. These are the consultations. So, they cover how many of the 70?

Mr. BHATIA. It's not a simple area. There are 9 subsidies at issue. Some are in those 70 and some are things that we found on our own. So, they're not—it's not an easy answer, but there are 9 subsidies at issue.

Chairman LEVIN. By the way, a lot of these subsidies, some of them were known years ago. I won't bother you with the list, but many of them were known as early as '90, '91, and in some cases, before.

Okay. So, you say of the 70—well, the consultation covers 9 of them?

Mr. BHATIA. Yes, that's right.

Chairman LEVIN. Okay. So, that leaves a lot of them out.

Mr. BHATIA. That's correct.

Chairman LEVIN. So, tell us as quickly as you can the strategy why those 9, what about all the others?

Mr. BHATIA. Should I go ahead and respond now, Mr. Chairman? Okay. Would you like me to respond—you had a couple of other points that I'd be happy to touch on. Okay.

Chairman LEVIN. Touch on everything.

Mr. BHATIA. Okay. Why don't we start maybe with this last one.

Chairman LEVIN. Okay.

Mr. BHATIA. Then I can go back through some of the others. The Chinese subsidy notification was filed last spring after we pushed substantially—during China's accession process, they made a commitment, or indicated that they would seek to provide the information about subsidies over the course of time. We—this did precede me joining USTR, but over the course of that period from 2001 onwards, there was a steady push to try and get them to supply that information. Ultimately last year, they did indeed supply it.

At that point in time, we reviewed obviously that list of subsidies, looking for those that were actionable in the WTO, to figure out what the consequences—and figure out what they were. There are two types of subsidies that are effectively actionable in the WTO. There are those that are prohibited, and those that—the 9 that we have sought consultations right now are what's called prohibited subsidies.

Two types of prohibited subsidies fall into that category. The first are export-linked subsidies, subsidies that are provided, say tax benefits or other things that are provided to companies contingent upon them exporting as opposed to producing for the domestic market; and import substitution subsidies, those that are awarded conditional upon companies in China using domestically made inputs rather than imported inputs.

Those two types of subsidies are so clearly trade distorting that the WTO has deemed them prohibited subsidies. You don't need to prove injury. There are a variety of other provisions that apply, and it allows you to move on a very fast track with respect to them. That is what we have done so with respect to these 9.

The other subsidies, indeed, and you refer to the 61, and there are—we pretty confident there probably are others out there as well, but those are a more complex matter to litigate. They may be actionable, they may not be actionable. Briefly, without getting too deeply into the weeds here, for a subsidy to be actionable under the WTO, what one needs to prove is a couple of things. First of all, that there is a financial contribution by the government. Secondly, that it is specific, specific to an industry or industries. Thirdly, that there is a benefit accrued by that industry or industries. Finally, that it is having an adverse effect on the U.S. industry, that we would be able to show that.

That is a much more complex endeavor, Mr. Chairman, than simply demonstrating a prohibited subsidy. A prohibited subsidy is basically a *de jure* case. An actionable, nonprohibited subsidy that still might be in contradiction with the WTO rules, requires the building up of a case, a very detailed, factually driven case.

We have spoken with a number of industries about other subsidies, including some industry—well, a number of industries about subsidies that are of concern to them, and if we believe that there is a strong case there to be brought, and if that industry, frankly, provides us with the information demonstrating that there is a strong case here, believe me, we're not going to hesitate from using the WTO litigation route if that proves to be the optimal way to proceed.

Mr. Chairman, maybe I could touch on a few of the other things that you raised—

Chairman LEVIN. Please.

Mr. BHATIA [continuing]. In response. Actually, perhaps I could just add one final point on subsidies. I think your focusing this hearing on subsidies is extremely valuable, and I think it is valuable because in my mind, and I think in our eyes, the role of the Chinese government influencing and directing its economy is perhaps the central challenge that we face in our trade policy going forward. There are many other challenges, IPR and other things are key, and don't mean to diminish them.

Ensuring that China reforms—continues on the path of reform that it has been on to move toward a more market-based system of economic—a more market-based economy, I think is the greatest challenge that we face, and I think subsidies is a key window into that problem, and thus the importance of our case.

I think, frankly, I think it is a very important case that we brought 2 weeks ago, because I think it will signal to the Chinese

and indeed to the rest of the world that we are approaching this issue and we are going to be using the WTO mechanism to address what we see as being a systemic problem. This doesn't affect just one industry. This potentially affects all industries, and it potentially distorts the global economy as well as the Chinese economy. So, we are very cognizant of the importance of the subsidies issue, and we'll continue to pursue it.

If I perhaps could just touch on these other issues. The 421 case, the issue of 421 that you mentioned, Mr. Chairman, during my tenure at USTR, I have been involved with one of these cases, the steel pipe case that you reference, and perhaps I could touch on that. I think it in some sense it reflects the same analysis that applies to some of the other cases.

We gave tremendously careful consideration to the 421 petition that was filed and did so relying upon and looking closely at the ITC analysis that was done as well. As you know, Mr. Chairman you were—you clearly were involved in the PNTR decision. The 421 analysis ultimately involves and contemplates a balancing test. One has to consider the national economic interest as well as the injury to the affected industry.

That is precisely what we did in this case. I think there were two reasons that drove the decisionmaking there. One is, would the remedy that the industry was seeking ultimately have been effective? Secondly, what was the national economic interest? What did the balancing test counsel in favor of?

When you look at what the structure of this market was, we could have imposed—had we imposed—let me put it that way. Had we imposed the sought quotas on pipes coming out of China, there were somewhere between 40 and 50 other countries that were suppliers in this area.

So, I think there was a strong case, there was a very strong case. There was, frankly, I think compelling evidence that even had we imposed quotas, the effect of those quotas would have been nullified through imports from other countries.

The second point to made on that subject is the balancing test, the issue of the national economic interests. At the end of the day, the ITC analysis that we were provided with suggested that the damages to the general economy, the damage—the cost to the general economy. Excuse me, not damage. The cost to the general economy would have been five times greater from imposing these than not imposing them, imposing the quotas, which is not to suggest, I don't in any way mean to suggest that we are not concerned about the fate of the workers and the manufacturing plants that you were talking about.

Clearly, imports are important. They are important because they bring into focus the impact of globalization and trade with China, but we were administering, and I feel very confident of this, we have administered 421 consistent with the statutory language and the statutory intent.

Last, with respect to 2008 and China taking a leap—excuse me, there are two other points. One is 2008. I am all for China pushing forward—indeed, let me say it this way. We believe China needs to be brought into compliance with its WTO commitments, and 2008 is a bit far off, frankly. We are pushing China on every WTO

commitment that we are aware of where they're not in compliance to bring them into compliance, and yet China has emerged onto the global scene, and it will continue—it will play an even larger role with the Olympics. I agree with that.

Right now, and this is what our top-to-bottom review says, China is certainly one of these major beneficiaries of participating in the global trading system. It needs to live up to that. It needs to demonstrate a responsibility there that is commensurate with the benefit that it's getting. That means being in compliance with its WTO commitments, that means being in compliance with its JCCT commitments, and the top-to-bottom review is the strategy to pursue to get them there.

Last, you point out the exports rose by 13 billion whereas imports rose by 44. I'm not disputing those numbers at all. There is a trade deficit. There is a trade deficit that in our top-to-bottom review we have said is not sustainable politically or otherwise, but I do think it is important to note the growth, the trend in exports by U.S. exporters, manufactured, services and agriculture, is encouraging. It does show that China is a growing market for U.S. exports, and that is creating jobs.

So, I appreciate the liberty to respond at length.

Chairman LEVIN. Just briefly—by the way, Mr. Vargo's testimony about the drop in exports in manufacturing we want to look at. Let me just say on the pipe and tubes case, I think your looking at other suppliers is not consistent with the intent of the language. In terms of national economic impact, that always can be used as a reason, but this Administration has turned down four out of four of the 421s when there was an ITC recommendation. The message that sends is one of complacency to a very unbalanced relationship.

As I leave and Mr. Herger takes over, we had testimony from those in furniture. I'd like you to give us some specific response, and also the testimony from the steel industry. There has been a very major increase in steel production, as you know, in China.

Mr. BHATIA. Yes.

Chairman LEVIN. Subsidization is clearly part of it. We had better get ready to handle the issue of their increased imports here from subsidized industries. We better get ready.

Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman. Welcome to our Committee.

Mr. BHATIA. Thank you.

Mr. HERGER. Thank you for the work that you're doing. Really listening to the testimony and the questions from both sides of the aisle, it really sounds like we're on the same page. I think the big concern is are we moving quickly enough? Are we attacking the problem aggressively enough?

Yet putting this into perspective, just a decade and a half ago, where China, where the entire free world had virtually no contact at all with China, and to see how far we've come in such a relatively small period, short period of time. Those of us who have visited China, just to see this country taking off from the bicycle era which it was when I first visited there almost a decade and a half ago or so just seeing what's going on there.

Again, trying to put this in perspective, am I correct, of all the trading partners, all the U.S. trading partners that deal with China, is it correct that the United States is the only trading partner that's actually brought a case against China? I believe that was last year in the auto parts, and that now we've brought a second case, an additional case, and yet we have settled two or more without litigation?

Mr. BHATIA. Congressman, there are three cases, three requests for consultation, basically, the commencement of cases in the WTO that we have pursued. The first, a case with respect to value-added taxes on semiconductors, that case settled. The second is the auto parts case that we filed earlier—well, filed last year. That case was brought by the United States, but we were joined as co-complainants in that case by the European Union and by Canada. So, effectively, the three of us brought that case altogether.

The third is the subsidies case that we just brought, the United States just brought last—two weeks ago.

Mr. HERGER. How many cases have other trading partners that you—in addition to what you've just mentioned, Japan, other trading partners, how many cases have they brought?

Mr. BHATIA. Against China? None.

Mr. HERGER. So, as few as we've brought, no one else has brought any. This leads into my question. My concern is the fact that other countries would seem to be free riding, at least at this point, on the work that we've been doing, it would seem the only country that's aggressively pursuing dispute settlements with China is the United States.

Why would you say, why is it that other WTO members have not raised concerns similar to ours with China's implementation, and are we working with them in common areas of concern?

Mr. BHATIA. I think, Congressman Herger, there's probably a couple part answer to that.

Mr. HERGER. I might ask, these other countries are experiencing the same concerns we are, aren't they?

Mr. BHATIA. Yes. Yes they are I think.

Mr. HERGER. It's not just the United States that's—

Mr. BHATIA. I think that is a fair point. To some extent, China's commitments, have, as we've described, been phased in over the course of time. So, the fact that China acceded in '01 and that you're now seeing a greater amount of litigation recently I think is in part attributable to the fact that some of those commitments they had periods of time to come into compliance. I think that—I believe that you will see increased litigation against China not only by the United States but by others as we move further into that period effectively this point forward, in which China is obliged to be in compliance. I do think that's one case.

I think the United States, and I'm afraid this has been true for a long time, has played the role of leader in the WTO and elsewhere and in promoting compliance with global trading standards and requirements, and we're doing it again here with China. While we don't shy away from that role, we do it, I would point out that we are working more cooperatively I believe with our trading partners in a joint approach to promoting responsible WTO-compliant behavior by China than in years past.

I would point out the fact that with the auto parts case, we did work very closely with our colleagues in the European Union (EU) and Canada to bring that, that we have set up—last year we have set up some mechanisms, standing mechanisms by which we coordinate with our colleagues in the EU in Brussels, in Tokyo and elsewhere on China enforcement issues.

They will probably tell you—some of the things we hear from our trading partners abroad is it's got to be a multi-pronged approach to China, that sometimes litigation is the best way, sometimes dialog is the best way. We don't disagree with that. We ourselves pursue both dialog and litigation, but our view, as clearly expressed in the top-to-bottom, is that a strong enforcement prong has got to be a key part of that, and we look forward to our trading partners joining us in that going forward.

Mr. HERGER. Sir, are we working with them? You mentioned that the EU did join us in two of these, Japan. Do we have others that are working with us? Are we working to involve other countries as well to bring greater pressure on China to do the, quote, "right thing" and to live up to their commitments?

Mr. BHATIA. We are. We are, Congressman, and we do a fair amount—I think there is not a meeting that goes by where I don't meet with my EU counterpart, probably my Japanese counterpart, and my counterparts increasingly in other countries in the region where the subject of whether China is in compliance with WTO commitments and what we can do to help continue this process of reform does not come. So, we are regularly in contact with them.

Mr. HERGER. Very good. Thank you.

Mr. BHATIA. Thank you.

Chairman LEVIN. Thank you very much. Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman. Mr. Bhatia, welcome to the Committee.

Mr. BHATIA. Thank you.

Mr. CROWLEY. Mr. Bhatia, my city, New York, has a strong competitive advantage in the financial services sector, something that myself and a number of Members of the delegation guard very closely. New York companies are world leaders in financial services, yet many of these firms continue to have trouble gaining full access to the Chinese market even as our markets remain open to both Chinese goods and to Chinese services.

Can you describe some of the regulatory barriers to entry for U.S. firms into the Chinese financial services market and what is the Chinese government doing to reduce those barriers, and why do those barriers continue to exist even now, 5 years after China's entry into the WTO?

Mr. BHATIA. Congressman Crowley, the financial services commitments that China made are a very high priority for us. We recognize fully the importance of compliance with those commitments, not only because financial services, as you described, is a key area of, frankly, competitive advantage for the United States, but in fact it is I think critically important for China's own economic development; the rationalization of the Chinese economy that it open itself up in this area and it allow the sort of business practices and the skill sets that American financial services companies can offer to

be able to promote the kinds of reforms and changes that China needs.

So, I think this is a critically important area for us and for China. China's commitments, as you may know, were to phase out geographical client, scope of business limitations for foreign entities that provide banking services within 5 years of joining the WTO.

It also committed to remove market access limitations and provide national treatment for foreign suppliers of payment and money transmission services, including credit cards and charge cards and debit cards, and that commitment was supposed to become effective with respect to Ren Min Bi (RMB) denominated business, Chinese currency denominated business, with respect to the retail clients in China, no later than December 11th of last year. There are a variety of other commitments, including with respect to financial information, financial data processing.

Now China has issued new regulations. At the end of last year in November, just before the phase-in of the commitments, they did issue new regulations that allow foreign banks that incorporate in China as subsidiaries to provide a range of services, including doing domestic currency business with Chinese individuals.

We are working very closely with the financial community to figure out whether these new regulations are in fact and in practice bringing China into compliance with its WTO compliances. We do—I will be frank—we do have some preliminary concerns about the requirements and about restrictions.

Let me also mention if I can with respect to electronic payment services, I am disappointed, frankly, with China's—that China has not yet taken any action to implement its commitments to provide access to foreign providers by December 11th of last year, although we understand China may soon release regulations in that area.

We are watching that area closely. We are, as I say, in all of these areas in strong and steady contact with the business community, and we raise the issues frequently with the Chinese. Again, let me make clear, we will pursue ensuring that China is in compliance with its obligations in this and in other sectors, both through dialog and through use of WTO dispute settlement if necessary and if appropriate.

Mr. CROWLEY. Figuratism is a form of subsidization as well, I believe. I think that's what's going on China when it comes to the financial services sector in particular.

The WTO subsidy case that USTR recently filed I think was a good first step.

Mr. BHATIA. Thank you.

Mr. CROWLEY, but this case only covers 7 of the 70-plus subsidies China recently reported to the WTO four years after the required filing date, no less. Moreover, though, many analysts do not believe that China has fully notified the WTO, that it's not fully complete in terms of the number of subsidies that are offered.

Why didn't the USTR press the Chinese government to file its subsidies in a timely manner, and what steps is USTR taking to pressure China to eliminate those subsidies and to identify non-declared subsidies like favoritism?

Mr. BHATIA. Thank you, Congressman. Just in general, again, if I can make the point that we believe that subsidies and what

they represent basically in terms of the Chinese government attempting to pick winners and losers, to pick favorite sectors, to direct their economy, is not only a problem with respect to global imbalances, but fundamentally is a problem for a China itself as it seeks to pursue a path of economic development that is sustainable in the long run.

So, we are very much focused on the subsidies issue, as evidenced by the case that we brought. The case I think will have a—indeed, I already have reason to believe it is having a significant—it has been taken notice of by the Chinese as being an effort to correct policies that go beyond a single sector, but rather deal with the role that the Chinese government is playing in terms of influencing its broad economy.

If I could respond to your specific questions about the filing of the Chinese notification and then the remaining subsidies. The filing of the notification—China was in its WTO accession commitment—accession package—indicated that it would seek to provide notifications over the course of time. We, starting in '01 and continuing I can tell you until last May when we received—April or May when we received the notification, pushed the Chinese assiduously on this.

It was a major topic leading up to last year's JCCT, and indeed was notified almost contemporaneously with the JCCT, and it has given us some transparency into what is frankly a very opaque system. So, there was a real value to that.

The 70 subsidies notified, some of those subsidies have given rise to—their notification has given rise to the case that we brought. Some of the subsidies that we are targeting in the case frankly are things we discovered on our own, or were aware of outside of the subsidies notification. So, that is how we've pursued this.

The remaining subsidies are—the subsidies we have brought dispute settlement over are in our view clearly prohibited subsidies, by which we mean they are subsidies that are export-related or import substitution subsidies. They are so trade distorting that the WTO has clearly marked them off for specific treatment regardless of whether there is injury and so forth. That's that tranche of subsidies.

Beyond that, there are subsidies that may or may not be actionable under the WTO. It is important to recognize that just because it's a subsidy doesn't necessarily mean it's a WTO actionable subsidy, but there are subsidies that we are looking at and discussing with industry to see whether they meet the relevant definitions of being a WTO actionable subsidy; namely, that there is a financial contribution from the government, that it is specific to an industry or industries, that there is a benefit accrued by that industry, and that it causes harm.

If we see that pattern, and this really does depend upon getting a lot of information from our own industry, to be honest with you, but if we see that, we have made very clear we will not hesitate to use WTO dispute settlement as well as whatever other tools we have to try and address it. We do believe that this, again, as I started out with, subsidies is critically important.

Chairman LEVIN. Thank you. Let me just ask Mr. Crowley, Mr. Crowley, before you have to go, is it possible that a Chinese re-

quirement that a financial services institution—institute or institution—be a subsidiary of a Chinese entity, it's conceivable that that's WTO consistent?

Mr. BHATIA. Mr. Chairman—

Chairman LEVIN. I think in answer to Mr. Crowley you said that there was a new regulation.

Mr. BHATIA. Yes.

Chairman LEVIN. That it, I thought you said required that the entity be a subsidiary?

Mr. BHATIA. The issue is subsidy versus branching, is what we're talking about here. So, that these are regulations that the Chinese have put out to try and bring themselves into compliance with their WTO obligations that they have made, and we are trying to figure out whether as applied those requirements are going to be consistent with the WTO commitments they made.

Chairman LEVIN. Their regulation says what regarding being a sub or a branch?

Mr. BHATIA. The regulations allow foreign banks that have incorporated in China to provide the range of services that we're looking to allow our companies to be able to provide, including domestic currency transacted business.

Chairman LEVIN. So, they would allow a completely foreign-owned bank to have a full range of services?

Mr. BHATIA. We are trying to figure out whether the regulations as applied are going to permit that or not.

Chairman LEVIN. If they don't, it would be out of compliance?

Mr. BHATIA. It would, I think, Mr. Levin—I don't want to misspeak to you on whether there would be a WTO case there or not. I do know that our industry appears to be—well, our industry is concerned about being able to get access to the market. I think the subsidies versus branching issue is one that may be less pressing than ensuring that they ultimately have that access.

I'm happy to follow up with you on more detail on whether the regulations specifically on the subsidies versus branching issue are consistent with WTO requirements or not.

Chairman LEVIN. Okay. Lastly, when you referred to the request for consultations, when you referred to that, it's interesting that the footnotes, in the footnotes, you have your references to specific Chinese regulations or whatever, and most of them date back a number of years. So, it would seem that the document you filed shows that these were regulations or otherwise published by China many years ago.

Anyway, let's focus on the future now. By the way, I did ask the staff to look at the data of the Chinese surplus, and I guess you have to add the European Union countries together, but our deficit so overshadows that of any other country. I guess Canada is next. Japan, Mexico. So, we better be a leader. We've got the biggest deficit.

All right, Mr. Herger. Do you have any further questions?

Mr. HERGER. Maybe one last question, Mr. Chairman. Mr. Bhatia, the USTR brought the prohibited subsidy case against China because these prohibited subsidies are openly and publicly advertised.

The whole point of these subsidies was to attract foreign investment with these subsidies, and that can only occur if they are known and documented. Could you tell us what about the hard cases of hidden subsidies and what is the USTR's plan to root these out?

Mr. BHATIA. Congressman Herger, that is challenging. I don't deny the fact that the case we were able to bring, we were able to bring because it was a de jure claim, and it was—they were subsidies that were well known, and indeed the Chinese, with respect to some of them, had notified them.

There are hidden subsidies, subsidies that may occur in the form of concessionary financing or real estate for which there is not market prices charged or no price charged. There could be a bank funding or loans that are not—that don't need to be repaid or are forgiven. There are a variety of instruments that we are concerned about.

The challenge we have, to be frank, is a lot of that is very opaque. There isn't clear—there is not a great deal of clarity in that. I think we are approaching it several ways. First of all, we're working to try and make China more transparent. We are through the various dialogs, both the strategic economic dialog as well as the JCCTs, there is almost always a transparency feature to those as we've tried to move China along.

Indeed, I'd point to the last JCCT where one of the major successful outcomes was a commitment by China to enhance transparency with respect to at least regulations that it's putting forward. So, transparency is a key aim and goal.

I think secondly, we are trying to gather as much information as we can, principally by working with U.S. industry, about the hidden subsidies. It is—I will readily confess, it is not easy, but we are endeavoring to do so. We are working using U.S. Government resources and we are working using in collaboration with the private sector, and that's what we'll continue to do.

Mr. HERGER. Very good. Thank you.

Chairman LEVIN. Well, thank you very much. It's been very useful.

Mr. BHATIA. Thank you.

Chairman LEVIN. We'll be seeing much of each other.

Mr. BHATIA. I look forward to it.

Chairman LEVIN. We stand in adjournment.

[Whereupon, at 2:02 p.m., the hearing was adjourned.]

[Submissions for the Record follow:]

Statement of Advanced Medical Technology Association

We thank the Committee for holding this important Hearing today on China's use of subsidies and abuse of intellectual property rights (IPR). As you know, AdvaMed represents over 1,300 of the world's leading medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. Our members are devoted to the development of new technologies that allow patients to lead longer, healthier, and more productive lives. Together, our members manufacture nearly 90 percent of the \$86 billion in life-enhancing health care technology products purchased annually in the United States, and nearly 50 percent of the \$220 billion in medical technology products purchased globally. Exports in medical devices and diagnostics totaled \$25.5 billion in 2005, and imports were \$23.7 billion. The medical technology industry directly employs about 350,000 workers in the U.S.

The medical technology industry is fueled by intensive competition and the innovative energy of small companies—firms that drive very rapid innovation cycles among products, in many cases leading new product iterations every 18 months. Accordingly, our U.S. industry succeeds most in fair, transparent global markets where products can be adopted on their merits, and IPR are protected. We strongly support the Administration's effort to expand market access for U.S. products abroad through the World Trade Organization (WTO) negotiations and new free trade agreements (FTAs), as well as oversight of market access barriers in countries with which we have strong trade relationships. In addition, we believe U.S. participation in trade agreements is most effective when provisions are enforced.

Global Challenges

Innovative medical technologies offer an important solution for industrialized nations, including Japan and European Union members that face serious health care budget constraints and the demands of aging populations. Medical technologies also provide a way for emerging market countries, like China, to improve healthcare to their people, who are increasingly expecting substantially better healthcare to accompany rapid economic development. Advanced medical technology can not only save and enhance patients' lives, but also lower health care costs, improve the efficiency of the health care delivery system, and increase productivity by allowing people to return to work sooner.

To deliver this value to patients, our industry invests heavily in research and development (R&D). Today, our industry leads global medical technology R&D, both in terms of innovation as well as investment. The level of R&D spending in the medical devices and diagnostic industry, as a percent of sales, more than doubled during the 1990s—increasing from 5.4% in 1990 to 8.4% in 1995 and over 11% last year. In absolute terms, R&D spending has increased 20% on a cumulative annual basis since 1990. Our industry's level of spending on R&D is more than three times the overall U.S. average.

Despite the great advances the medical technology industry has made in improving patient quality of life and delivering considerable value for its innovations, patient access to critical medical technology advances can be hindered by onerous government policies. Patients and health care systems experience much less benefit from our industry's R&D investment when regulatory procedures are complex, non-transparent, or overly burdensome—all of which can significantly delay patient access and drive up costs. In the future, patients will be further disadvantaged if payment systems fail to provide appropriate payments for innovative products—which will subsequently affect the availability of R&D funds and the stream of new technologies.

The medical technology industry is facing these challenges around the world as governments enact more regulations. While we support those regulations that ensure product safety and efficacy, many others are being imposed without scientific justification, and in non-transparent processes, which only adds to costs and delays without improving patient outcomes.

As governments prioritize difficult budget decisions, they sometimes look to short-term decreases in health care expenditures without accurately assessing the long-term implications. In most cases, governments do not effectively measure the contributions medical technology makes in enhancing patient outcomes and productivity as well as expanding economic growth, which would more than offset the costs of providing these products. Instead, governments often inappropriately include reduced reimbursement rates as part of overall budget cuts.

In some cases, governments seek to reduce prices of medical technologies in their country by fixing ceiling prices. In the longer-term, patients in these countries and around the world will experience less access to innovative medical technologies, as research and development funds decrease. This is the situation we are facing in China.

Obstacles Impede Market Access in China

AdvaMed looks to the U.S. government to pursue trade liberalization throughout the Asia-Pacific region and to protect IPR. Because of its potential market size and government policies, China should remain a focus of U.S. Government attention.

China has quickly become an important market for the U.S. medical technology sector. The American Chamber of Commerce in China estimates that the Chinese market for medical technology exceeds \$8 billion and is growing rapidly. It is on pace to surpass some of the key European markets for medical technology in a few years. As global leaders, U.S. medical technology firms already account for a significant portion of sales in China and the position of these firms underscores the impor-

tance of ongoing efforts with the U.S. government to open the Chinese market further.

AdvaMed looks forward to working with Congress and the Administration to address the following barriers:

- A Lengthy and Costly Product Registration Process
- Redundancy in the Registration Process
- Lack of Transparency in Decision-Making
- Inappropriate Price Controls
- Counterfeiting and piracy of Medical Technology

For the medical technology industry, the Bush Administration's efforts with China under the U.S.-China Joint Commission on Commerce and Trade, as well as in less formal meetings, are critical for allowing U.S. medical technology firms broader access to the burgeoning Chinese health care market. The recently-launched U.S.-China Health Care Forum initiative, led by the U.S. Department of Commerce and supported by AdvaMed and other health care partners, holds great promise as another vehicle for addressing many of the trade-related and health policy-related barriers confronting U.S. medical technology firms in China. We also endorse including healthcare under the Strategic Economic Dialogue.

However, our trade agreements offer little leverage over some of China's policies that adversely affect our industry's market access. In particular, agencies in the Chinese Government appear to be pursuing an industrial policy, implementing measures that support certain domestic industries to take markets from foreign suppliers. Medical technology is one such industry.

The National Development and Reform Commission (NDRC) and the Shanghai Pricing Bureau (SPB)—which we believe are in close coordination—are demanding sensitive price, cost and marketing information from U.S. companies. We believe that this is part of China's industrial policy for its national medical technology industry. The State Council Opinions on Invigorating the Equipment Manufacturing Industry issued on June 28, 2006 clearly identifies the medical technology industry. In July 11, 2006, the NDRC issued a proposal to collect sensitive information from our companies. This proposal includes a policy rationale for controlling foreign manufacturers of medical technology, with an allegation that technology "monopoly" causes monopoly prices—which, of course, is not the situation in our highly competitive industry.

In addition, our company representatives report the theft of their intellectual property by some domestic firms. The use of this intellectual property obviously provides a competitive advantage, because such domestic firms do not have to devote hundreds of millions of dollars for research and development of their products. This means that domestic firms can produce medical devices at lower cost than foreign firms, not because of greater efficiencies but because they are not investing in research.

The detailed price information which the SPB is giving to local associations and which is likely to be shared more widely with domestic associations that are closely affiliated with the Chinese Government would increase the competitive advantage for domestic companies. Our competitors in China would very likely be able to obtain detailed product-specific price information, ranging from prices at origin, on foreign markets, at import, for wholesale, and for retail. Foreign companies would not have access to the same information about domestic firms. This result is both unfair and harmful to competition. In the United States, sharing price information among competitors would be contrary to anti-trust laws. If companies know what others are charging, there is a risk that prices will be coordinated and competition will be harmed.

The regulations imposed on our industry to provide detailed cost information would be unique. We know of no other industry in China that would be subjected to these types of requirements and controls—with the exception of the pharmaceutical industry for which China's accession commitment to the World Trade Organization includes a specific provision.

The net impact of these policies is an indirect subsidy for domestic Chinese medical technology companies. Price controls favor domestic Chinese companies. Such companies do not incur the R&D expenses, since they simply use U.S. technology. And, domestic companies have far lower overall production costs, for the many well-known reasons that favor Chinese manufactures. In a free and open market, our companies can compete effectively on the basis of quality and service. In a price-regulated market, with our domestic competitors receiving sensitive IP and economic information due to Chinese Government policies, the U.S. medical technology industry's ability to compete and to provide patients our innovative products is seriously eroded.

The medical technology industry has made a proposal to address China's legitimate concerns regarding rising healthcare costs and inappropriate distributor mark-ups. We hope continued U.S. Government support will provide us to opportunity to discuss this proposal with NDRC officials.

We also endorse efforts to convince China to enforce IPR. The U.S. medical technology industry depends on our ability to innovate and to have our new products protected.

Conclusion

AdvaMed appreciates the shared commitment by Congress and the President to expand international trade opportunities and encourage global trade liberalization. We look to the U.S. Government to aggressively combat barriers to trade throughout the globe, especially in China. AdvaMed is fully prepared to work with Congress to monitor, enforce and advance multilateral, regional and bilateral trade agreements, particularly with our key trading partners.

Statement of American Forest and Paper Association

The American Forest & Paper Association (AF&PA) appreciates this opportunity to present the forest and paper products industry's views regarding U.S. trade with China. AF&PA is the national trade association of the forest, pulp, paper, paperboard and wood products industry. The industry accounts for approximately 6 percent of the total U.S. manufacturing output, employs more than a million people, and ranks among the top 10 manufacturing employers in 42 states with an estimated payroll exceeding \$50 billion. Sales of the paper and forest products industry top \$230 billion annually in the U.S. and export markets. The more than 200 companies and related associations AF&PA represents have a strong interest in ensuring that commitments made by China are met so they can create a solid basis for the continued growth of business opportunities.

As is the case with many U.S. manufacturing industries, we face increasing domestic and international challenges. Since early 1997, 128 pulp and paper mills have closed in the U.S., contributing to a loss of 85,000 jobs, or 39 percent of our workforce. An additional 60,000 jobs have been lost in the wood products industry since 1997.

China's spectacular economic growth in the last decade is having a dramatic impact on the global economy. In the forest products sector, the speed in which China has become a major player has greatly influenced global supply and trade pattern. The increasing trade flows also have frequently been associated with unsustainable harvesting and illegal logging in other Asian countries and Russia that supply timber to the Chinese market.

AF&PA worked hard with others in the American business community in support of China's membership in the World Trade Organization (WTO). Since its WTO accession in 2001, China has implemented many economic and regulatory reforms that have allowed it to achieve tremendous economic success. However, the government continues to use subsidies and other industrial policies to protect and nurture Chinese industries. In the paper and wood processing industries, the result has been a substantial expansion in China's production and exports over a very brief time period and a corresponding drop in market opportunities for U.S. manufacturers. This is incongruous since China doesn't have the fiber resources necessary for a competitive forest products industry, and is largely dependent on imported fiber in the form of logs and other wood products, wood pulp and recovered paper.

U.S. TRADE WITH CHINA

China has the fastest growing forest products industry in the world. However, with limited forest resources, China has to import a significant amount of raw material in the form of logs, chips, pulp and recovered paper. The total value of Chinese forest products imports reached \$17.8 billion in 2006, an increase of 72 percent since 2000. Imports include \$6.5 billion in wood products and \$7.1 billion in wood pulp and recovered paper. However, China's drive to meet rising demand by heavily investing in domestic production, has meant that imports of products such as paper and paperboard have stagnated over the last six years. In 2006, paper and paperboard imports amounted to \$4.2 billion, a decrease from a year earlier, and just 7 percent higher than in 2000, at a time when China's paper and paperboard consumption in volume terms rose by more than 70 percent.

China's imports from the U.S. increasingly consist of raw materials in the form of wood pulp and recovered paper as furnish for the Chinese paper industry; and

of logs and lumber for manufacturing solid wood products, furniture and other wood products. In 2006, China's imports of these products from the U.S. amounted to \$1.86 billion, or 66 percent of total U.S. forest products shipments to China. In the past several years, raw materials have represented a very high, and growing share of China's forest products imports from the U.S. For example, imports of recovered paper from the U.S. rose by over 182 percent in the 2002–2006 period to \$1.27 billion. In addition, China's hardwood logs imports from the U.S. almost quadrupled during this period to \$109 million.

In contrast, Chinese exports of forest products to the U.S. increasingly consist of processed and finished products. For instance, Chinese exports of coated free sheet—a paper product suitable for high-end print projects, magazines, advertising, and brochures—reached \$225 million last year, almost double the amount recorded in 2005, and up from practically zero in 2000. Just ten years ago, China had no capability to produce international grade coated paper. Furthermore, Chinese exports of converted paper and paperboard products, such as, packaging paper, boxes, cartons and school supply paper reached approximately \$1 billion in 2006, which represented 72 percent of all Chinese paper product exports to the U.S. last year.

In terms of wood products, China continues to be an important market for U.S. producers, particularly for hardwoods. China's imports of U.S. hardwood lumber, logs and veneer exceeded \$477 million in 2006. Increasingly, many U.S. wood products are used in domestic application for furniture, interiors and outdoor construction, but also for the production of picture frames and other value-added wood articles principally manufactured for export to the U.S., Europe and other global markets.

China also is becoming a significant supplier of primary wood products such as lumber and plywood. It is the second largest supplier of wood product imports to the U.S., and the largest supplier of plywood and veneer imports. According to U.S. trade statistics, the U.S. imported \$3 billion of lumber and wood products from China in 2006, almost treble the amount in 2002. Of the total, imports of plywood and veneer were \$982 million last year, a 60 percent increase from 2005. We have received reports that some Chinese oak-faced plywood has been mislabeled as birch-faced plywood in order to avoid the 8 percent duty on the former.

AF&PA believes that as long as China fails to fully comply with its obligations as a member of the WTO the longer-term export prospects are not encouraging for U.S. manufacturers of forest products. This is the case as China's production capacity for paper and paperboard and for lumber and wood products is rising rapidly, and for some grades in excess of domestic demand, largely with the direction and support of the government and government owned or government controlled banks. Consequently, this is displacing imports in key grades and leading to growing Chinese exports, a trend that will likely accelerate if current non-market economic and trade policies remain in place.

ANTIDUMPING MEASURES

China has been very aggressive in using antidumping investigations as a tool to protect and promote manufacturing sectors identified by the government as growth industries. Since the late 1990's, U.S. paper and paperboard producers have been subject to four antidumping investigations specifically in those segments of the industry where Chinese manufacturing capacity has been rapidly expanding, including newsprint, coated printing paper and kraft linerboard. This section will highlight several important issues from our industry's recent experience in the kraft linerboard case which was terminated earlier last year only after USTR informed the Chinese mission in Geneva that the U.S. was going to ask for consultation under WTO proceedings.

- **Lack of Transparency and Failure to Make Timely Disclosure:** When China's Ministry of Commerce (MOFCOM) initiated antidumping investigation against kraft linerboard imports it did not make the full text of the petition immediately available to all known affected exporters. This is inconsistent with the requirements of Article 6.1.3 of the WTO Antidumping Agreement. Furthermore, when MOFCOM issued the preliminary determination on May 31, 2005, it formally refused to disclose to AF&PA the aggregate data on which it based its injury determination. This is at odds with China's obligations as it interfered with the ability of U.S. exporters to defend their interests in this case. Full disclosure of all such information should be provided. In explaining the reason for terminating the final determination, MOFCOM acknowledged that the investigating authorities failed to provide some basic facts to interested parties before issuing the final determination.
- **Inadequate Injury and Causation Analysis:** The preliminary and final determinations in the kraft linerboard case didn't provide evidence of a causal link

between the subject imports and the alleged injury to the Chinese domestic industry as is required by Article 3.5 of the WTO Antidumping Agreement. Specifically, MOFCOM failed to adequately account for the alleged injury caused to the domestic industry by its rapid expansion in capacity and production in excess of the growth in demand. This is a fundamental failure to abide by WTO rules, which mandate that an investigating authority examine the injury caused by factors other than the subject imports to ensure that the injury from such factors is not improperly attributed to imports.

- **Improper Cumulation:** MOFCOM improperly cumulated the linerboard products exported to China by the three other countries subject to the AD investigation with the kraft linerboard exported by the U.S. even though these products differed in significant respect from the U.S. product, including quality, physical characteristics, and price. The cumulation of these products violated Article 3.3 of the WTO Agreement and contributed to the erroneous injury analysis.

Even though MOFCOM eventually rescinded the AD duties, this was almost 2 years after the launch of the investigation. In the meantime, the uncertainty created by the case caused long-term disruption and loss of business for U.S. kraft linerboard suppliers.

SUBSIDIES

The Chinese government has encouraged the development of a world-class forest products industry through domestic investment and expansion of paper and forest products manufacturing operations. Many of the measures used to achieve the rapid and massive industry expansion that has taken place in China in recent years include direct and indirect subsidies that may not be WTO-legal. Since many of the Chinese forest products companies are engaged in international trade or compete against imports, they have an unfair competitive advantage versus U.S.-based companies that must rely on financing at market rates.

In the past several years, AF&PA has examined and documented the various financial, trade and policy measures that the Chinese government is using to build its fiber resources and its pulp, paper and wood processing industries. Our research found that the Chinese government employs direct and indirect subsidies—for example grants, low interest loans and debt forgiveness—to prop up state-owned enterprises, introduce new technology, and build massive new production capacity.

The Chinese government acknowledged just as much during the kraft linerboard antidumping investigation noted in the previous section. In the preliminary determination, MOFCOM explicitly acknowledged that the Chinese linerboard industry was targeted for government promotion. Such promotional policies explain the growth of domestic industry capacity and production in excess of demand. The result has been an erosion in market share for imports, both from the U.S. and others countries.

AF&PA was pleased that the United States, in October 2004, submitted questions to China in the WTO on its subsidy practices, including a series of specific questions on subsidies in the forest products sector. China committed to respond to these questions by the end of 2005. So far, however, China has failed to provide information in response to the Article 25.8 request filed by the U.S. in 2004.

We note that China's 11th Five Year Plan might signal an important change in emphasis from previous plans when it comes to government policy toward industry. Based on publicly available information, it seems that the new Five Year Plan has a more market oriented approach toward economic development and addresses some of the "unhealthy" outcomes of China's rapid industrial expansion, namely the potential for environmental pollution, excessive energy and water consumption, and China's raw material deficit. We hope that greater government concern about the negative impacts of excessive investment will lead to more balanced and sustainable growth in China's paper production and capacity. In the meantime, AF&PA supports the continued efforts by the U.S. at all levels to impress on China the need to reign in and ultimately eliminate industrial subsidies.

U.S. industries have not been able to resort to the use of countervailing duty (CVD) law to counter subsidized imports from China. Since 1984, the U.S. Commerce Department has not applied CVD law to non-market economies (NMEs) such as China, even though the WTO does not prohibit the application of CVD law to NMEs. AF&PA, and a large group of U.S. industries, supports legislation to clarify the intent of Congress by expressly providing for the application of CVD provisions to China and other NMEs.

CURRENCY MANIPULATION

The controlled undervaluation of China's currency has nullified that country's WTO market access commitments. While AF&PA welcomed the slight revaluation

of the Yuan in July 2005, the meager appreciation of China's currency since that time in spite of the country's strong economic, financial and trade performance indicates that the Chinese government continues to tightly manage its currency to support its export led growth. As a result, U.S. manufacturers, including U.S. producers of forest and paper products, remain at a significant competitive disadvantage when exporting to China or when competing in the U.S. or third country markets against Chinese exports.

The Chinese government's active intervention in foreign exchange markets to keep its currency undervalued offsets the market access benefits the U.S. negotiated under China's WTO accession agreement. The General Agreement on Tariffs and Trade (GATT) Article XV, now incorporated within the WTO, addresses Exchange Arrangements and stipulates that members should not take exchange rate actions which "frustrate the intent of the provisions of this Agreement", namely, negotiated reduction of tariffs and other barriers to trade. For this reason, AF&PA believes that the U.S. Administration should continue to press the Chinese government to allow the value of its currency to reflect economic fundamentals.

ILLEGAL LOGGING

The presence of illegally procured wood fiber in several international forest products markets affects the competitiveness of U.S. producers who operate legitimately within national and international environmental and trade rules. In the case of China, U.S. trade opportunities are directly affected by the abundance of illegally harvested timber from a number of regional sources. China, which is the world's second largest importer of wood products, is laundering much of this illegal product through its manufacturing sector. It is estimated that 40 percent of Russian logs entering China are suspicious (potentially illegal) because of excess cutting, harvesting without authorization or as undocumented/unreported exports. China's imports of hardwood logs also come from countries with significant problems with illegal logging (Indonesia is the largest supplier of hardwood to China).

A study commissioned by AF&PA, *Illegal Logging and Global Wood Markets: The Competitive Impact on the U.S. Wood Products Industry* (November 2004), examined the flow of suspicious roundwood into the lumber and plywood sectors estimated that the value of U.S. wood exports could increase by over \$460 million annually were there no illegally harvested wood in the global market. The elimination of illegally harvested wood in the global market would also have an effect on the pulp and paper sector. China plays a key role in the global equation.

Illegal logging, associated illegal border trade, and the use of illegally obtained timber in manufacturing distort international trade and reduce market opportunities for U.S. suppliers. China needs to take immediate steps to improve its on-the-ground enforcement capabilities and improve monitoring systems that better regulate cross border trade. AF&PA supports comprehensive compliance efforts by the U.S. Government to ensure that the U.S. industry has a fair chance to compete in China and in third country markets where our industry competes against Chinese suppliers.

REFERENCE PRICING

China applies reference prices when calculating duties for imports of certain wood products. As these reference prices seem to be set unreasonably high, the result is higher duties than would be the case if the invoice value of the shipment was taken into account. Sources also indicate that local customs officials develop their own reference prices independently, which means different customs posts use different reference prices.

It is unclear why China is applying reference prices when calculating duties on wood products. The WTO rules on the calculation of duties state that the "transaction value" is the primary method from which to determine duties, and if the "transaction value" cannot be easily determined, the rules set out a series of alternatives, for instance, the value of an identical or similar imported good, which must be agreed to between the importer and customs authorities. Reference prices to determine duties are not permitted under WTO rules.

RESTRICTIVE CODES AND STANDARDS

Even though the U.S. has been successful in having China adopt U.S. design values and grading rules for common species of U.S. softwood dimension lumber into its revised GB50005-2003 (design code) and GB50206 (inspection code), there is no requirement in either code regarding materials quality conformance, such as requirements for grade-stamps for dimension lumber, wood-based structural panels and preservative-treated wood. This could potentially create quality problems for these wood products and compromise safety for structures built with such non-conforming structural products.

Currently, China is developing product standards for dimension lumber, wood-based structural panels and engineered wood products and fasteners. In some cases, local builders use non-structural plywood as sheathing or floor material. Even though progress has been made in the area of revising China's Timber Structure Design Code and Timber Construction Inspection Code to incorporate U.S. design values, grading rules and species, more work is needed regarding the development of product standards, product certification inspections and building site conformity inspections to ensure Chinese engineers, inspectors and consumers can determine the quality of structural material. The absence of a formal recognition of U.S. certification agencies and their grading rules/marks, for example, may lead to an increase in the counterfeiting of building materials, or misleading labels being placed on products, which has already been evidenced in the Chinese marketplace.

CONCLUSION

The rapidly developing Chinese economy should represent a strong potential for increased exports of U.S. wood and paper products. However, that potential has not been fully realized as a result of economic and trade distorting practices outlined above. To ensure that our industry has a fair chance to compete in the Chinese market, AF&PA strongly supports comprehensive efforts by the U.S. Government to ensure that China complies with its WTO market access commitments.

AF&PA believes that China has a long way to go in addressing its economic and trade distorting policies and practices before it can be considered to be a market economy. The Administration should address the critical issues of antidumping practices, subsidies, currency manipulation, restrictive codes and standards, and illegal logging in ongoing discussions with the Chinese government.

AF&PA appreciates this opportunity to provide comments to the committee on our industry's views about trade with China. We look forward to working with the committee in the 110th Congress to address these critical issues.

Statement of Americans For Fair Taxation, Conyers, Georgia

Trade policies through the WTO as the arbitrator places restrictions on the U.S.'s negotiating powers. Rather than trying to promote exports through free trade agreements with other countries, Congress should enact needed tax reform legislation to make trading with the United States a desired goal of other countries.

Free trade is never really free either. It is a convoluted set of tax treaties negotiated not for the benefit of the employer/exporter, but rather between the governments to produce a neutral equation of tax revenues paid to each countries government coffers.

It would be in the United States best interest to push for an overhaul of our tax system by replacing the income tax with H.R. 25, The Fair Tax. A system that does not place any tax on exports to other countries automatically drives other countries to manufacture or source the manufacture of their goods here in the U.S., rather than their own country or elsewhere. This drives up the desirability of the United States for a trading partner with anyone since our goods will be produces more cheaply than our current system allows.

American Apparel and Footwear Association
February 26, 2007

The Honorable Sander M. Levin, Chair
Ways and Means Trade Subcommittee
U.S. House of Representatives
Washington, DC

Dear Chairman Levin:

Thank you for providing us this opportunity to submit this statement in relation to the hearing cited above.

The American Apparel & Footwear Association (AAFA) is the national trade association representing the apparel and footwear industries, and their suppliers. Our members produce and market apparel and footwear throughout the United States and the world, including China. In short, our members make everywhere and sell everywhere.

I would like to take this opportunity to briefly describe the importance of China to the U.S. apparel and footwear industries and how our relationship with China benefits U.S. apparel and footwear firms, U.S. workers, U.S. consumers and, in turn, the U.S. economy. I will also discuss our concerns and hopes for this relationship in the future, particularly as it relates to the focus of this hearing—i.e. Intellectual Property Rights (IPR) and subsidies.

Our Industry—Then & Now

But first, a little background on our industries. Our industries have historically been among the most protected industries in the United States—subject to decades of stiff protection in the form of high tariffs and restrictive quotas (for apparel). Even today, U.S. apparel and footwear imports from China are still subject to high tariffs and, in the case of apparel, quotas.

Yet, this incredible protection failed to do the very thing it was supposed to do, protect the U.S. apparel and footwear manufacturing base. Today, more than 98 percent of all footwear and more than 90 percent of all apparel sold in the United States is imported. For comparison, in 1980, only one-half of all footwear and less than one-third of all apparel sold in the United States was imported.

Today, less than 630,000 people work in the manufacturing of apparel, textiles and shoes in the United States—a loss of over 1.6 million jobs, or almost three-quarters of the entire manufacturing workforce since 1974. Almost 1 million of those jobs have been lost in the last decade alone.

Despite this seemingly bleak picture, the U.S. apparel and footwear market is booming. Americans like their clothes, and their shoes, and it shows. U.S. consumers spent a record \$350 billion on apparel and footwear last year, or an average of \$1,800 for every man, woman and child in the United States. Even as energy prices skyrocketed last year, retail sales at clothing and footwear stores were 6.1 percent higher than in 2005. The bottom line is that despite whatever economic pressures face us, Americans still buy new things to wear. Americans, however, are picky about their shoes and clothes, they continually want an ever-wider variety of higher-quality shoes and clothes at lower prices—and our industry has had to respond.

U.S. footwear and apparel firms have responded to these challenges by transforming themselves from manufacturers into brands. Today's U.S. apparel and footwear "brands" are more lean and more competitive than ever—their goal is to provide the American consumer with what they want—the best brands at the best prices, while still making a profit.

And the result of this is that U.S. apparel and footwear firms are thriving, with many achieving profits last year—profits that go directly back into the U.S. economy and ensure a competitive industry.

Further, while the industry has lost over one million manufacturing jobs in the last decade, the industry has produced hundreds of thousands of good-paying new jobs for U.S. workers—not in manufacturing, but in such varied professions as design, research and development, marketing, distribution, sourcing, warehousing, management, administration and sales. Further, the industry directly supports another 1.5 million plus jobs at retail establishments throughout the United States.

The industry's transformation has directly benefited U.S. consumers—particularly hardworking lower- and middle-income American families—by lowering prices on one of the most basic staples every man, woman and child needs. As a result of the industry's transformation, apparel and footwear retail prices have declined some 10 percent since 1998, despite a 20 percent increase in overall retail prices during the same period—saving American families countless billions of dollars every year—money they pump back into the U.S. economy.

Thanks to these lower prices, American families today spend a smaller percentage of their income on shoes and clothes, a necessity for every American, and instead spend more elsewhere. According to the U.S. Department of Commerce's Bureau of Economic Analysis, the percentage of the average American family's Personal Consumption Expenditures (PCE) spent on clothes and shoes has dropped by almost one-half since 1977—from 6.6 percent of total PCE in 1977 to less than 3.9 percent today. With consumer spending driving over 2/3 of our Gross Domestic Product (GDP), the decline in U.S. apparel and footwear prices has helped fuel the overall economy.

China's Relationship with the U.S. Apparel & Footwear Industry

The U.S. apparel and footwear industry could not have succeeded in transforming into the success that it has become today without the existence of China. Working for the most part with foreign-owned and privately-held factories in China, U.S. ap-

parel and footwear firms have been able to give American consumers what they want—an ever-wider variety of higher-quality shoes and clothes at lower prices.

Today, this relationship is stronger than ever. U.S. footwear and apparel firms imported over \$30 billion worth of footwear and apparel from China. U.S. imports from China account for over 85 percent of all shoes and over 25 percent of clothes sold in the United States.

Opening the Chinese Market to U.S. Apparel and Footwear Brands

There Has Been Progress, but More Must be Done

U.S. footwear and apparel firms, however, recognize that 95 percent of the world's population lives outside the United States. Some of their fastest growing markets are no longer in the United States or Europe, but in China, or India or Brazil. U.S. apparel and footwear firms are now truly global—they buy and sell clothes and shoes all over the world. That is why AAF's motto is—"We Dress the World."

That is why our industry was one of the biggest supporters of China entering the World Trade Organization (WTO), not just because of our relationship with China as a supplier to the U.S. market, but because we wanted to use WTO rules to open China—with the world's largest middle class of 200 million people and growing—to U.S. brands. Since China's WTO accession, our industry has worked closely with the U.S. government and the rest of the U.S. business community to ensure that China lives up to its commitment in opening up its distribution and retail sectors. Thanks to our efforts, China has largely lived up to those commitments, opening the doors to U.S. brands to sell into the vast Chinese market. While U.S. brands have had some success in China because of these efforts, restrictions still exist in these sectors. We hope the Chinese fully live up to their commitments in these areas.

Intellectual Property Rights (IPR)

Moreover, we have been deeply disappointed with the progress made to date on China's efforts to improve its Intellectual Property Rights (IPR) enforcement. U.S. footwear and apparel brands have been subject to rampant counterfeiting in China, stalling our efforts to break into this important market.

This problem even affects us in our home market—the United States. Every year, clothes and shoes top the list of counterfeit items seized by U.S. Customs. We estimate that these seizures represent only a small fraction of the total amount of counterfeit shoes and clothes entering the U.S. market.

China must do more on IPR enforcement. While we continue to support the dialogue between the U.S. and Chinese governments on this subject, the Chinese must move beyond talk and take action. Otherwise, the U.S. government must take action.

Subsidies

We applaud the Bush administration in initiating a case against China in the World Trade Organization (WTO) again China's continued use of WTO-Prohibited Subsidies. Such subsidies can truly distort trade in certain products and industries. Further, the arbitrary nature of such subsidies, where China has provided and then removed such subsidies without notice, creates immense uncertainty for our industry.

Next Steps—the U.S. Apparel and Footwear Industry View

As we noted, China still has a long way to go in meeting its international obligations—as both a major economic power and as a major market for U.S. brands and U.S. products. We fully support the current administration's efforts to address these many issues through dialogue. As we also noted, however, our industry would support further actions in specific instances where dialogue continues to produce less than desired results.

I would, however, caution those who would propose certain "remedies" for the purpose of resolving many of these issues. First, many of the proposed "solutions" clearly violate U.S. obligations under international trade rules. While many might not be concerned about this, this violation is of critical concern to our industry. As I mentioned previously, U.S. apparel and footwear firms make and sell everywhere around the world, including selling clothes and shoes made in China into major markets like Europe, Brazil and India. Any action taken by the United States against China that violates international trade rules would not only be closely watched by these countries but quickly replicated, closing these important markets to U.S. brands.

Second, many of these proposed "remedies" would impose significant penalties, in the form of punitive duties or other restrictions, on some or all U.S. imports from China. As I have already stated, virtually all clothes and shoes sold in the United

States are imported, with a significant portion being imported from China. Similar situations exist for a multitude of other consumer products. If such “remedies” are imposed, those remedies would amount to huge new tax on hardworking American families—at a time when many of these families could least afford it.

Finally, such actions could actually hurt the very U.S. manufacturing base these measures are supposedly trying to protect. Regrettably, recent history has repeatedly demonstrated this fact—our members’ products—U.S.-made apparel and footwear—figured prominently on foreign country retaliation lists in both the WTO dispute over Foreign Sales Corporations (FSC) and in the WTO dispute over the Byrd Amendment. These punitive measures severely crippled what remains of the U.S. apparel and footwear manufacturing industries as it essentially closed their primary export market for U.S.-made footwear and apparel—Europe.

The U.S. apparel and footwear industry recognizes that many important issues exist in the U.S.-China relationship—issues that directly affect U.S. apparel and footwear firms. However, as in the case of our industry, the relationship between the United States and China is one that is critically important to and very intertwined with the U.S. economy. Therefore, I urge policymakers to carefully consider all aspects of this vital and complicated relationship before setting new policy.

Thank you for your time and consideration in this matter.

Sincerely,

Kevin M. Burke
President & CEO

Statement of Coalition of Service Industries

China’s Implementation of WTO Commitments

Thank you, Mr. Chairman and members of the Subcommittee, for the opportunity to express the views of the Coalition of Service Industries (CSI) on U.S.-China services trade and China’s implementation of WTO services commitments. CSI is the leading business association dedicated to reducing barriers to U.S. services exports and mobilizing support for policies that enhance the global competitiveness of U.S. service providers. Our membership consists of U.S. corporations and associations engaged in many commercially important services sectors. Many of our member companies have significant presence in China and are deeply interested in China’s full implementation of its WTO commitments and the continuation of its sectoral reforms.

Since WTO accession, China has conducted comprehensive trade reforms that opened key services sectors to foreign participants, improved trade policy predictability, and expanded China’s foreign markets. According to the World Bank, Chinese global cross-border services exports grew from \$5.7 billion in 1990 to \$62 billion in 2004. China’s exports in travel, IT and communication services were especially strong. U.S. cross-border exports to China also increased by 61% from \$5.6 billion in 2001 to \$9 billion in 2005. The U.S. services trade surplus with China now stands at \$2.6 billion, and is based on strong U.S. exports in business, professional, educational, financial, and telecommunications services.

Despite the robust growth of U.S.-China services trade, China’s economy is unbalanced, because its policies continue to favor export-oriented manufacturing sectors, as opposed to local consumption-generated growth based on demand. As a result of these skewed policies, Chinese services sectors have experienced lower growth than the goods sector, and comprise only 41% of GDP. This is less than the average services GDP in low and middle income countries, and much lower than in the U.S., where private services are 78% of output, and 80% of private sector employment.

The development of China’s services sector is also hampered because U.S. companies are still unable to take full advantage of its WTO commitments due to erratic implementation. In our reviews of China’s services trade record, we specifically stressed systemic, cross-cutting issues, such as market access and national treatment, poor services infrastructure, the lack of transparency, the lack of intellectual property rights (IPR) protection, and other challenges. We support the U.S. Government’s decision to raise these overarching issues at the U.S.-China Strategic Economic Dialogue (SED), which we urgently hope will also create a solid foundation for solving many sector-specific trade impediments in other forums.

Structural and Systemic Issues for Strategic Economic Dialogue

CSI members support the objective that the SED process should remove structural barriers that impede both China’s growth and U.S. access to its markets through trade and investment. Services sectors have become increasingly important

to China's further infrastructure growth and global competitiveness. Therefore, we suggest that the SED forum focus on the following systemic issues:

Increased Regulatory and Licensing Transparency

It is in China's interest to fully embrace regulatory transparency. China made substantial WTO commitments to regulatory and licensing transparency, such as notice and comment requirements for new trade laws and regulations, improved licensing procedures, and judicial review. However, full implementation of these commitments simply has not taken hold in the Chinese bureaucracy. Chinese laws, regulations, and administrative practices frequently change without warning, and are frequently not applied uniformly. We are also concerned that China's rules often provide regulators with broad discretion, resulting in unpredictable rules and decisions.

A modern economy requires transparent government and regulation. Transparent rule-making and licensing are one of the best ways to fight corruption in China. Through consistent, adequate notice and comment periods and the involvement of key stakeholders in the regulatory development process, many outstanding specific trade and investment problems U.S. companies continue to confront might be eliminated.

We also encourage the Chinese Government to seek active participation by all stakeholders in regulatory reform. The review of the postal legislation, for example, would benefit from active consultation with the private express delivery industry. China should also consult with the private sector on its pending telecom bill, draft insurance law, and other important sectoral legislation. The opportunity for meaningful public comment on China's legislative measures is required by GATS rules on transparency and China's WTO accession commitments on notice and comment.

Strengthening Key Regulatory Institutions

Chinese officials acknowledge that their regulatory agencies for securities, insurance, and other services are not sufficiently developed. China's trade negotiators have repeatedly used this argument as a reason to deny better offers on services. We suggest that USTR, Treasury, and other agencies offer technical assistance to help the Chinese strengthen their regulatory institutions. For instance, the Chinese telecom regulator is not sufficiently independent in its functions and responsibilities from the state-owned telecom monopolies. Enactment of a Telecom Law that would establish an independent regulator could serve as the basis for a significant expansion of the telecom sector and those industries that depend on competitive telecom services. U.S. experience with telecommunication regulation could surely be useful!

Financial Sector Modernization

The structural rigidities of the Chinese financial system are well known. The system perpetuates bad loans from state banks to state enterprises, starves small and medium services companies of funds and encourages investment in sectors suffering from overcapacity, which leads to China's continued exploitation of export markets. All this results in poor savings returns for Chinese citizens and widespread economic inefficiencies. Chinese leaders have indicated they are aware of these shortcomings and of the need to strengthen the Chinese financial services sector.

China's objective of modernizing its financial sector can be achieved by continuing to liberalize foreign investment policies in the financial services sector. China will need to redouble its efforts to increase regulatory transparency, permit full foreign ownership of investments, and offer a full choice of juridical form.

A more open market will allow foreign financial services suppliers to introduce new and innovative products that could serve as models for health insurance coverage, retirement savings, and accidental death and dismemberment benefit plans. This will require full national treatment for foreign firms in all areas affecting operation and expansion of business.

Promoting Innovation and Technical Assistance

Because China and the U.S. share the goal of promoting innovation in services to secure economic growth, both countries should collaborate on research and development of the new field of "services science." Services science is a multidisciplinary field that combines training for technology, science, management and engineering skills. IBM is partnering with the Chinese Ministry of Education and leading universities to develop this new academic field of study, and collaboration between research universities in both countries provides an excellent partnership opportunity.

We support and encourage China's ambitious goal of developing a competitive IT and computer and related services sector. However, this requires the Chinese Government's strong commitment to preparing a globally competitive workforce. U.S. associations and their members have the necessary expertise in the training and

certification of highly skilled IT services specialists, and can help Chinese authorities to meet their export and domestic IT worker development goals.

In its “Opinion on the Reform and Development of the Insurance Industry” of June 26, 2006, the Chinese State Council states that foreign insurers should be relied upon as a source of innovation and high standards, and that market demand should be the driving force in determining the need for new products. China Insurance Regulatory Commission (CIRC) leadership endorses these goals. Nevertheless, the current regulatory process does not allow for the rapid approval of new products and appropriate tax treatment to encourage the sale of sophisticated new policies. For example, CIRC has failed to allow foreign carriers to provide political risk insurance for Chinese companies with exposures in foreign markets, even though there is keen demand for this product. Additionally, the inadequate tax deductibility of producer commissions hinders the sale of sophisticated insurance products.

Increased Market Access in Sectors Dependent on Intellectual Property Rights (IPR) Protection

Elimination of China’s trade barriers in audiovisual, software, and IT goods and services is one of the factors that can help solve China’s piracy problem and foster sound investment and economic growth, benefiting both U.S. and Chinese producers. However, current trade barriers and regulations make it difficult for U.S. companies to enter the Chinese market to supply legitimate IPR products, thereby ceding the market to counterfeit and pirate products.

China’s piracy and counterfeiting at the wholesale and retail levels, end-user piracy, Internet piracy, multi-channel signal piracy, and unauthorized access to ‘overspill’ satellite pay-TV programs remain rampant due to lenient penalties, uncoordinated enforcement among local and national authorities, and the lack of transparency in administrative and criminal enforcement. The piracy rate for optical media products and software is reported to be over 90 percent. China’s law still stipulates inadequate criminal liability for copyright offenses, e.g., corporate end-user and Internet piracy, unclear protection for temporary copies, and overly broad exceptions to protection of computer software. Criminal prosecution of piracy remains restricted by the Chinese criminal code, which requires a demonstration that piracy is occurring for the purpose of making a profit.

Sector-Specific Issues for Joint Commission on Commerce and Trade

In addition to its overarching systemic issues, China should resolve the following sector-specific issues, which are addressed mainly at the Joint Commission on Commerce and Trade (JCCT). We appreciate that the U.S. Government also raises these sector-specific trade barriers at Transitional Review Mechanism (TRM) meetings in the WTO, but we are disappointed at China’s lack of responsiveness to these efforts. It is essential that China honor its WTO services obligations and carry out its commitments in the JCCT.

Financial Services

CSI has been working closely with the U.S. Government to urge the Chinese leadership to implement its existing WTO commitments fully and liberalize China’s financial services sector further. The Chinese Government should improve its WTO financial services commitments to reflect the following principles: the ability to own 100% of investments; establish in the juridical form of choice; enjoy non-discriminatory, national treatment in all aspects of business; have permission to supply services cross-border to sophisticated consumers; and rely on greater regulatory transparency with effective notice and comment periods. These principles would give U.S. financial firms new, commercially meaningful opportunities in China.

Insurance

After issuing the amendment to China’s Insurance Law in 2003, CIRC followed with important implementing rules regarding the administration of insurance companies, asset management, risk control and other aspects of insurance regulation. We appreciate that CIRC also allowed interested parties to provide comments on the draft Insurance Law. Despite these developments, significant market access and national treatment concerns remain:

- **Branching.** The ability to grow business geographically through branch and sub-branch expansion is the most important issue for many foreign insurance companies in China. We are concerned that branch approvals for U.S. providers are still being granted one at a time, while established and start-up Chinese companies receive approval to open multiple branches. This practice is contrary to international practice, impedes competition, and most importantly violates China’s WTO national treatment commitment for insurance. Senior officials at

CIRC have confirmed to USTR their commitment to allow foreign companies to establish multiple concurrent branches. We are pleased with this statement, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC officials. Most important of all is a change in actual practice.

Subsidiary Conversion Despite CIRC's effective requirement that foreign-owned insurers convert their Chinese operations from branches to subsidiaries (notwithstanding China's WTO commitment to allow foreign general insurers to operate on either a branch or subsidiary basis), the regulator continues to delay approval of companies' applications for such conversion. This delay contravenes CIRC's own regulation (Baojian Fa 45, page 3, section 6) that requires its response to applications within two months. The delay—over a year for some companies—has created uncertainty and confusion in corporate planning as insurers eager to expand can only apply for permission to open new offices three months after the conversion process is approved. We urge CIRC to adhere to its own regulation and approve applications on a timely basis.

- **Capitalization Requirements.** CIRC should confirm that the RMB 200 million capital requirement for initial establishment, whether as a subsidiary or a branch, includes the right to establish sub-branches without limitation on numbers, and without having to satisfy any additional capital requirements. The Chinese government has yet to provide its rationale for requiring additional capital of RMB 20 million for each additional branch, particularly given that any additional branches would still be backed by the full asset base of the admitted entity and have to comply with all CIRC solvency rules.
- **Overseas Utilization of Insurance Foreign Exchange Funds.** CIRC's Provisional Measures on the Administration of the Overseas Utilization of Insurance Foreign Exchange Funds establish a qualifying threshold (total assets of RMB 5 billion) for companies to invest their foreign exchange capital in overseas funds or equities. CSI members are concerned that even though this limitation applies to both domestic and foreign providers, only the largest insurers, i.e., mostly domestic companies, will have the necessary assets to qualify. Many foreign-invested insurers will not qualify unless CIRC recognizes the assets of the parent foreign company when determining the asset level of a foreign-invested company.
- **Insurance Asset Management Restrictions.** Under Article 8 of CIRC's Interim Regulations for Insurance Assets Management Companies, only providers that have held licenses for more than eight years are permitted to apply to establish an insurance asset management company. Although China previously stated that this limitation applies to both domestic and foreign providers, it effectively excludes all foreign companies entering the market since China's WTO accession in 2001.
- **Reinsurance.** Senior officials at CIRC have confirmed to USTR their commitment to allow foreign reinsurance and insurance companies to conduct cross border reinsurance with Chinese direct insurers or reinsurers on a national treatment basis. We applaud this action, and would call on CIRC to confirm this intention in an administrative clarification to all CIRC officials. This clarification should state that China will suspend implementation of the 2005 Regulations on Administration of Reinsurance Business, as the regulation discriminates against foreign reinsurance companies by requiring right of first refusal for 50% of each primary company's reinsurance program with domestically admitted reinsurers. CIRC should also clarify that for purposes of these measures a 100% foreign-owned insurance operation may cede to a parent or affiliate insurance company.
- **Acquired Rights.** Companies operating in China at the time of WTO accession are entitled to continue operating and geographically expand their business on the basis of their previous juridical form.

Asset Management and Securities

Foreign firms are currently permitted to own 49% of joint-venture asset management firms in China, consistent with China's WTO accession commitments. We strongly urge China to go beyond its WTO commitments by allowing foreign firms to choose their form of establishment and equity participation levels, and permitting competition on the same basis as domestic firms.

For asset management firms, the Chinese Joint Venture Rules require foreign firms to have at least RMB300 million (U.S.\$39 million) in paid-in capital to qualify as a joint venture partner. This requirement is significantly higher than in other jurisdictions, and serves as a market barrier to U.S. companies. Asset management firms do not need large amounts of capital to protect investors because their busi-

ness is not capital intensive, and client assets typically are not at risk if the asset manager experiences financial difficulties.

A high regulatory capital requirement disproportionately affects foreign asset managers because their operations are typically not as significant as their operations in their home country. As a result, domestic firms will be able to comply with a large capital requirement more easily than foreign firms. Additionally, while large banks or broker dealers may not find it difficult to meet high capital requirements, many smaller, independent firms are part of the highly successful asset management industry in the United States.

We are encouraged by recent developments that allow Chinese nationals and corporations to invest in overseas markets as qualified domestic institutional investors (QDIIs). We hope that the new rules will be implemented in a fair and transparent manner that allows all qualified asset managers—domestic and foreign—to participate on an equal basis.

Although we are pleased that China took steps to open the A-share market to foreign investors by adopting rules on qualified foreign institutional investors (QFIIIs), the CSRC and SAFE have been slow to amend the rules to increase their practicality. We understand that anticipated revisions would address many of our concerns, including a reduction of the lock-up period from one year to three months and a simplified approval process for remittances, but these revisions have been delayed repeatedly. We urge greater liberalization of the QFII regime to remove restrictions on investment by QFIIs.

Pensions

CSI members are pleased that the Chinese government has issued its new enterprise annuity initiative to provide better retirement security for its citizens. However, the new regulations are incomplete and ambiguous. Thus, we suggest that the enterprise annuity rules be clarified further, and implemented in a transparent and predictable way. To ensure companies' compliance, China should specifically clarify the licensing process and procedures, and provide information on the regulatory and supervisory authorities, and operation requirements, with a view to securing a level playing field among the various financial services entities that offer such products. We would also suggest that pension providers be permitted to apply for a comprehensive license covering all required entities (Trustee, Custodian, Record Keeping and Fund Management), such that they can service all aspects, including a pension plan member's retirement plan.

In May 2005, it was reported that the Ministry of Labor and Social Security (MOLSS) had stopped accepting applications for enterprise pension funds. Although MOLSS has indicated that there will be future application periods, it has not identified the date when applications will be accepted again.

CSI members also suggest that China adopt a universal approach to taxation of pension plans and that its tax regime enable employers to make tax-favored contributions to employees' pension plans. Tax rules should provide tax deferral for individuals that contribute to defined contribution pension accounts, similar to U.S. 401(k) plans. As the U.S. experience shows, tax incentives are essential for strong and healthy development of private pension plans.

We also encourage the Chinese pension regulator to promote high sectoral standards and professional management by separating financial companies' pension operations from other businesses. This can be done through establishing pension subsidiaries, a trust entity, such as a master trust, which would provide for financial protection of pension plan members, or setting up a mechanism to better separate pension assets from other assets.

Electronic Payment Services

Although China represents an extremely large potential market for the vibrant U.S. electronic payments industry, U.S. electronic payments providers, global leaders in these services, have very limited market access in China. Currently, foreign electronic payments cards cannot be issued by any bank (local or foreign) unless they are co-branded with China UnionPay (CUP). CUP was established by the People's Bank of China (PBOC) in 2002 as a monopoly domestic electronic payments provider and processor. We believe these restrictions violate China's accession commitments in financial services, which came into force on December 11, 2006.

The PBOC has asserted that allowing foreign banks to issue CUP credit and debit cards to Chinese consumers by the December 11 deadline was all that was required for China to meet its WTO commitments. This is clearly not the case. China's GATS schedule requires that it provide for unrestricted market access and national treatment for "payments and money transmission services, including credit, charge, and debit cards." This means that China must allow financial institutions to issue pay-

ment cards of their choice and permit foreign providers to process both foreign currency and domestic currency transactions without CUP involvement. Banks cannot be required to issue only one brand or co-branded domestic payment cards.

In addition, China committed to unrestricted market access and national treatment for “advisory, intermediation, and other auxiliary financial services” for other financial services listed in its schedule, including payments. China also committed to open market access for the “provision and transfer of financial information, and financial data processing—by supplier[s] of other financial services,” and took no exceptions that would allow any domestic payments processor to operate as a monopoly.

WTO also mandates that countries may not use standards to exclude foreign service providers in sectors in which they have made specific commitments. Thus, China must adopt standards for electronic payments processors that are neutral in law and fact.

Telecommunications

China’s narrow interpretation of market access opportunities for foreign participants and lack of an independent regulator remain key outstanding issues, which contradict its WTO accession commitments. Specifically, foreign market entry is being delayed by the Ministry of Information Industry’s definition of value-added services (VAS) for international value added network service licensing. The regulator has construed the meaning of VAS in China’s WTO commitments so narrowly that any commercially important sectors, such as IP-virtual private networks (IP-VPN) services demanded by global enterprises, are excluded.

China’s unreasonably high capitalization requirements for basic services and the prohibition on resale absent a basic services license have also greatly limited market access in both basic telecommunications and VAS. We believe that resale should be permitted, and subject to appropriately lower market entry requirements. Further, the requirement that foreign telecom service providers may only enter into a joint venture with one of the existing state-owned enterprise telecom providers is problematic.

Contrary to its claims, China has not implemented its WTO Reference Paper commitment to establish an independent regulator. The Chinese Government still owns and controls all major telecom operators, and the Ministry of Information Industry serves in the chain of command as a leader rather than a regulator of the sector.

Despite the WTO commitment to discuss further sectoral liberalization, China has yet to submit an improved telecom offer with broader market access, including higher foreign equity participation.

The industry hoped that the JCCT Telecom Dialogue would offer a useful vehicle to ensure China’s WTO compliance and advance industry interests in liberalizing its telecommunications market. The Telecom Dialogue is already well into its second year with no tangible progress evident. At last year’s JCCT Plenary meeting, the U.S. government was able to obtain China’s commitment to address the capitalization requirement. We look forward to its substantial reduction, but there has been no progress to date.

Express Delivery

U.S. express delivery service (EDS) industry members are concerned that the Chinese government has not yet released the details of its plans for postal reform and that it has not taken into account the serious concerns that the industry has expressed about the draft postal law. The opportunity to review the postal reform plan and draft law, and the opportunity for meaningful public comment on China’s postal measures are required by GATS rules on transparency and China’s WTO accession commitments on notice and comment.

The current (eighth) draft postal law—which industry has not been allowed to see—reportedly attempts to narrowly define express delivery services contrary to China’s WTO market access commitments, and includes national treatment violations for domestic delivery services. The law would grant China Post a monopoly on letter delivery with two exceptions. The first exception would allow for international express letter delivery, subject to a separate set of regulations. The second would apply to letters and certain official documents of more than 150 grams. However, the second exception is not available to foreign-invested EDS suppliers, and would explicitly prohibit foreign-invested enterprises from supplying domestic express letter delivery services in China.

China’s draft law and postal reform plan would apply a tax on all entities operating under the expanded postal monopoly. The current draft does not include specific percentages for a universal postal service fund tax. We are concerned that this measure would result in millions of dollars of lost revenue for U.S. companies and

would increase the cost of trade. At the same time, it is unclear how this fund would be used by China Post, so there is a possibility that it would be used to subsidize its express delivery services.

The draft would also grant new powers to the State Postal Bureau (SPB) to regulate the international express industry. This includes subjecting mergers and acquisitions of EDS companies' operations in China to review and approval by the SPB.

We understand that the eighth draft includes several articles that give state-owned China Post, its subsidiaries and branches, including its express delivery arm EMS, many competitive advantages against private companies. These advantages include exemption from traffic regulations; expedited priority dispatch ensured by other transportation companies; preferential access to air, rail and sea transport; as well as potential tax breaks and subsidies. In addition, postal enterprises that engage in competitive letter express businesses like EMS are not subject to the licensing requirements that other express delivery companies must follow.

China Post's Entrustments Issue

Despite Chinese government assurances and published regulations stating that entrustment certificates from China Post would be processed one time only and be valid for the duration of the firms' international freight forwarder licenses (i.e., several years), the SPB granted these certificates for a limited time only, most recently for the calendar year 2007. Although those same assurances and regulations state that firms would be granted one entrustment at the national level and the new branches would be "recorded" with the SPB, the SPB has directed companies to entrust locally. However, the local Postal Authorities in headquarters' jurisdiction claim that they lack the authority to entrust more than headquarters' operations. This entrustment regime violates China's WTO commitments not to roll back companies' market access rights and not to use licensing procedures to restrain foreign competition.

Freight Forwarding and Logistics Services

Revised international freight forwarding (IFF) rules issued on December 1, 2005, implement China's commitment to allow wholly foreign owned IFF ventures, but regulations published by the Civil Aviation Administration limit the ability of wholly foreign owned IFF enterprises to provide the full range of such services. To book cargo space on an airline in China, an IFF enterprise must obtain an Air Freight Sales Agency License from the CAAC. There are two categories of air freight sales agency licenses: Class A, which allows the holder to book cargo space on international flights; and Class B, which allows the holder to book cargo space on domestic flights. Wholly foreign owned enterprises are unable to obtain these licenses, which are available only to domestic firms and joint ventures.

We believe this restriction is a violation of China's WTO full market access commitments in freight forwarding agency services (CPC 748 and 749) under "Services auxiliary to all modes of transport." The explanatory note to the CPC system clearly and explicitly includes aircraft space brokerage services. If China intended to require licensing, and such licensing would have limited market access, such an exception should have been explicitly scheduled in the services schedule included in the Protocol of Accession.

Audiovisual, Publishing, and IT Products and Services

We encourage China to remove its limitations on foreign ownership in distribution and video replication, publishing, TV stations, and theater holding companies as one means to curb piracy. The elimination of market access barriers to distribute foreign pay TV programs and services, and an increase in the number of foreign revenue-sharing films allowed into the Chinese market are also important. Some of the piracy issues can be alleviated by allowing foreign media companies to have a greater stake in their Chinese investments.

China's WTO accession commitments in audiovisual services allow for foreign minority participation in cinema operations. However, China refuses to permit foreign majority enterprises, except in select cases that were grandfathered under a terminated experimental policy to allow up to 75% foreign investment in select cities. China also insists that the foreign partner cannot serve as Chairman of the cinema joint venture even if approved by its board. In addition, China does not permit the licensing of foreign pay television services, which stifles the growth of its cable and digital platforms.

China increased the number of foreign revenue-sharing films allowed into the market each year to 20, a minimal market opening measure. The terms of the revenue-sharing contract are dictated by the Chinese Government, and are not commercially reasonable by any standard. China continues to disrupt orderly marketing by instituting blackout periods when foreign films cannot be shown, and by impos-

ing revenue targets. The orderly distribution of home entertainment products is also impaired by the imposition of rules restricting the choice of business partners, and by the terms of commercial agreements. In addition, China maintains primetime broadcasting and foreign content restrictions in pay and non-pay television. All these restrictions, along with the lengthy approval process, only serve to expand the spread of illegal pirated content.

In the audiovisual distribution services sector, China is not abiding by its retail distribution services commitments, which are to allow foreign majority control with the ability to sell AV products. Contrary to this commitment, China has restricted foreign majority controlled retailers from securing AV retailing licenses.

In the publishing sector, control over content remains strict and China has stated that it will not approve any more foreign titles under Chinese publishing licenses except technical and scientific publications. We find this decision troubling and urge China to reconsider it.

Government Procurement of Software

We welcome China's commitment to begin formal Government Procurement Agreement (GPA) negotiations and submit its Appendix I offer by the end of 2007. In the interim, China should withhold implementing new procurement regulations that do not conform to GPA principles, including the Implementing Draft Measures on Government Procurement of Software of March 2005. CSI members are concerned that these draft measures provide for strong preferential treatment for Chinese suppliers by restricting government procurement to domestic software products. To qualify as "domestic," these products must be "manufactured" in China and the China-based development cost of the software must be at least 50%. The software copyright must also be owned by a Chinese entity or first registered in China.

China's draft measures also contain a procurement preference for open source software that is inconsistent with international practice, the WTO Government Procurement Agreement, and sound, efficient, and merit-based procurement policy. We believe that any procurement regime should be based on performance, and not favor any technology or licensing model.

The draft measures propose the possible purchase of foreign software only on the basis of product-by-product waivers, and only if the software provider satisfies unspecified requirements with respect to the level of the company's investment, R&D expenditures, outsourcing work performed, or taxes paid in China. Thus, this exception will benefit a small group of providers, and will not promote the ultimate goal of developing a competitive, advanced software industry in China, based on international best practice.

China's domestic preference policy contradicts the general trend in international trade and procurement law toward open, transparent, technology-neutral, and non-discriminatory access to global markets. The measures will severely limit market access of our members, especially software companies, to China's government procurement, and will create a dangerous precedent for other sectors. The rules also run counter to the spirit of openness China committed to when it became a WTO member and assumed observer status with respect to the WTO Government Procurement Agreement.

Conclusion

China's WTO accession opened a very important services market to U.S. suppliers, but China's services sector reforms must be fully implemented and, for maximal benefit, go beyond WTO commitments. As China's manufacturing experience shows, an open market provided many benefits to the Chinese economy. There is no reason why the same policy would fail in services.

China's full implementation of services commitments and continued services trade liberalization can promote the development of its services sectors, increase the inflow of services investment, and help resolve its complex economic and social issues. To build the infrastructure of a modern economy, China will have to rely on sophisticated services offered by foreign companies.

As a large exporter, China also has a significant stake in promoting globalization under the Doha Development Agenda. Despite its growing role in global trade, China has not been an active proponent of ambitious trade offers in services. The success of the Doha Round depends on constructive participation of key developing countries, such as China. We hope the Chinese Government will be a "responsible stakeholder" and step up its negotiating efforts by submitting a high-value services offer and encouraging other important developing countries to do the same.



**Statement of Usha C. V. Haley, University of New Haven,
West Haven, Connecticut**

Thank you Trade Subcommittee Chairman Levin and honorable members of the Committee of Ways and Means, for the invitation to address such a distinguished and thoughtful group. I apologize for my inability to be present as I am currently conducting research in Asia, but appreciate the opportunity to present a written statement for the record in lieu of my personal appearance. My statement focuses on the roles and effects of on-the book and off-the book subsidies in the Chinese market and their impacts on competition with U.S. products in China.

In line with its admittance into the WTO, the Chinese government agreed to implement most of its key commitments on the opening of markets by December 2004. Yet, in February 2007, China's implementation work remains incomplete. China's refusal to adhere to WTO compliance efforts stems in part from its inability to accept the key WTO principles of market access, non-discrimination and national treatment. Additionally, market mechanisms in China remain undeveloped, making its trade regime unpredictable and opaque. Although China implemented some key reforms, it has continued to use an array of industrial policy tools in 2006 to promote or to protect favored sectors and industries, and these tools at times collide with China's WTO obligations.

Industrial subsidies in China derive from governmental dominance of the economy and from various factors including the central, provincial and municipal governments' strategic goals, patronage, and corruption. The subsidies include direct and indirect components that affect both the top and bottom lines of industrial operations. My statement stems from research that I have conducted over the last eight years on business in China, some of which has been published in my book, *The Chinese Tao of Business: the Logic of Successful Business Strategy* (John Wiley & Sons). My statement covers forms of subsidies in China, impediments to monitoring these subsidies, specific subsidies for the 11th 5-year program period, Chinese governmental policies behind subsidies, and finally, how subsidies affect the profitabilities of foreign-invested enterprises (FIEs).

Forms of Subsidies

State subsidies primarily flow into State-Owned Enterprises (SOEs) although some well-connected private firms also benefit from indirect subsidies such as Special Market Information. Currently, the state controls about half the industrial output and SOEs still account for 35% of urban employment. Almost all of China's heavy industry and much of its technology lies in governmental hands. The government controls about a third of China's economy through SOEs in key sectors such as defense and utilities. The State Owned Assets Supervision and Administration Committee (SASAC) directly manages the top 190 or so SOEs, the biggest of which have international stock-market listings.

Subsidies exist in all industries that the Chinese state and provincial governments considered economically or militarily strategic, including Resource Extraction, Steel, Computing, Software, R & D, Environmental Services and Conservation, and Autos.

The subsidies exist in various forms, including those directly affecting international trade such as:

- a. export subsidies for FIEs and SOEs that meet certain export performance requirements. FIEs accounted for about 60 percent of China's exports of manufactured goods in 2005. The vast majority of FIEs that exporting goods from China have corporate ties to countries neighboring China.
- b. import-substitution subsidies that discourage purchases of foreign products by providing generous incentives for companies in China for buying domestic products rather than imports from the USA or other countries.

The Chinese central and provincial governments support both on-the-book and off-the book subsidies for domestic companies. Off-the book subsidies are far more pervasive and influential but also far more difficult to measure and to ascertain. Subsidies include:

1. **Free to Low-cost Loans:** The government exercises a vice-like grip on banks, stock markets and bond issuance and these translate to the ability to make grandiose loans. The most extreme statistics in the financial sector deal with loans outstanding. In three years from 2002 to 2004, loans increased by 58 per cent, or \$785 billion. In 2003, new lending equaled almost one quarter of gross domestic product (GDP). A credit binge fueled this latest boom. Half of all bank loans go to SOEs. Most of these loans will never be repaid. Huawei for example, has a \$10 billion credit line from China Development Bank. Dis-

counted lending rates are also available to SOEs and domestic companies that satisfy certain export performance requirements

2. **Asset Injections:** The SOEs' parent companies, usually municipal governments or ministries, provide their protégés with opportunities to acquire state-run businesses, such as toll bridges, at highly preferential terms which help pay down their costs.
3. **No Break-even:** Poor book-keeping practices, and lax bottom-line considerations, grant SOEs freedom from the need to make profits, or to break even. "Pure state-controlled enterprises" have no disclosure requirements.
4. **Subsidized Purchases:** SOEs can purchase their components and raw materials below cost and directly from each other, affecting the competitiveness of certain sectors in the global economy. This tradition propelled the Chinese motorcycle industry's ability to buy control of virtually all Indian motorcycle companies short of Bajaj and turn them into assemblers of Chinese components.
5. **International Bargaining Power:** Beijing has used its enormous buying power to intercede for its SOEs with foreign suppliers and to reduce acquisition costs for raw materials. A recent example includes the Chinese government's aborted attempt to bully down the cost of iron ore for the Chinese steel industry below internationally-negotiated price levels. The Chinese government has also secured contracts and exploration rights abroad for its SOEs.
6. **Labor Controls:** The government exercises various methods to control employees including the *dang'an* or employment dossier; and to reduce labor costs through injection of part-time and migrant workers and the use of prison labor. The government also offers exemptions from mandatory worker-benefit contributions to companies that satisfy certain export performance requirements
7. **Tax Breaks:** Many SOEs avoid taxation or reduce it through tax breaks (although this can backfire if a company's management loses favor). Income tax reductions and refunds are available to companies that satisfy certain export performance requirements and that purchase Chinese-made equipment and accessories rather than imports
8. **Energy and Land Subsidies:** The state subsidizes gasoline and electricity. Currently, Beijing tightly controls the price of both gasoline and electricity at well below their true economic levels. The state also offers free land and utilities to SOEs and companies in key strategic sectors.
9. **Tariff and VAT Exemptions:** The state offers Value-added tax (VAT) and tariff exemptions to companies that satisfy certain export performance requirements. The state also offers VAT refunds to companies that purchase Chinese-made equipment and accessories rather than imports
10. **Sectoral Credit Allocation:** The Chinese economy speeds up or slows down on a sector-by-sector basis on credit allocations by Beijing. Some sectors such as automotive, steel, ethylene and metals' smelting have come off the boil. Others sectors such as coal, railways and utilities are still getting huge infusions of policy-mandated credit. Very high levels of bureaucratic interference characterize credit allocations and industrial-project approvals in China and the state banking system does not allow the market to price capital.
11. **Stock Listings:** SOEs and Collectives form over 93 percent of the listing of approximately 1300 companies on China's Shanghai and Shenzhen Stock Exchanges. Provincial governments pressure government regulators to discriminate against private companies and give the precious slots to their ailing state dinosaurs. Indeed, private companies without state connections cannot obtain a listing on any Chinese stock exchange
12. **Cheap Technology:** China runs a deficit on its technology trade with the rest of the world and FIEs control 80 percent of technological imports and exports in China. The Chinese have made little progress in either basic research or advanced design in vital industries. Despite this institutional flaw, SOEs such as Huawei owe much of their success to lax enforcement of laws governing the theft of intellectual property.
13. **Control over Distribution Channels:** Provincial and municipal governments control distribution channels to allocate and to manage market share, to protect favored industries from competition and to shape investment patterns. Regulations on distribution incorporate considerable ambiguities leading to both legitimate differences in interpretation and considerable legal efforts to find loopholes. Central and provincial governments routinely use this ambiguity to confer privileges on favored companies or industries, and to withhold normal rights from companies or industries as a form of protectionism. Local administrators have been known to seize goods being trans-

ported and to refuse transportation of goods through their jurisdictions. Administrative guidance from various and competing sources can override the basic laws or regulations either explicitly or unofficially. Provincial or municipal governments may interfere with the national limits on distribution by their generosity (to lure investment or to meet local goals) or restrictions (to protect local interests). *Guanxi* with local army officials assumes particular importance for distribution. Some estimates suggest that the Peoples' Liberation Army (PLA) controls distribution of goods for up to about 80 percent of the Chinese population. Its control over manufacturing facilities also makes the PLA China's largest and most diversified manufacturer of industrial and consumer goods.

14. **Special Market Information:** Relevant information for strategic decisions comes at a premium price in China and often includes what we in the USA would consider Insider Information. In China, the central government deliberately controls and disseminates information that it considers of strategic importance. When restrictions on distribution insulate foreign or Chinese companies from their customers, they also cannot undertake direct market research and have to rely on less-sophisticated surrogates. For example, General Motors' (GMs') interns in Beijing have scoured the capital's streets to find out who is buying their cars after the intermediaries get them, so that GM can build *guanxi* with the buyers.
15. **Undervalued Currency:** The Chinese government's deliberate undervaluation of the yuan makes U.S. products more expensive for Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the USA, and therefore U.S. consumers purchase more of them, contributing to the record-high and still-growing U.S. trade deficit. The undervalued Chinese currency harms U.S. competitiveness and encourages the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.

Monitoring Subsidies in China

Lack of transparency affects ability to monitor all forms of subsidy except perhaps Stock Listings. Opacity serves as a tax which

1. Reduces ability to determine the true efficiency and productivity of China's labor and results in potentially sub-optimal foreign direct investment (FDI) decisions until after commitments are made. Consequently, our research has shown that FDI enjoys higher ROIs and ROEs across entire industrial sectors in India against China, including Capital Goods; Food Beverage and Tobacco; Materials; Pharmaceuticals and Biotech; and, Software and Services.
2. Reduces the ability of U.S. domestic producers to prove dumping, especially as so many of those affected are Small and Medium-sized Enterprises with limited resources.
3. Magnifies the weakness of China's statistical system which depends too much on reporting and too little on sampling; the statistical system shows a systematic bias to over-report growth at the bottom of the economic cycle and under-report it at the top, i.e. to flatten out a much more volatile economic cycle. Recently, some foreign companies have started constructing their own physical-activity indices of everything from freight-barge traffic to power consumption and air miles flown to find true economic indicators, but the enormous expense constrains companies from doing this well.
4. Reduces the credibility of the SOEs' books. For example, in 2003, China's top 500 SOEs reported revenues of 4.07 trillion yuan up 25 percent from the previous year; and profits of 334 billion yuan, up 33 percent from the previous year. Only 87 of the 500 reported making losses. Unfortunately, outright fraud aside, most SOEs' managers do not know their real profits and tell their supervisors what they want to hear

Unreliability in macroeconomic data also seriously compounds the problem of estimating the effects of subsidies.

- For example, in February 2002, the Chinese government said that China's GDP had grown by 7.3 percent in 2001, making it the world's fastest-growing economy. However, growth rates reported by individual provinces told another story. Only one, Yunnan, said its product had grown slower than the national rate. Taken together, the provincial figures produced a national growth rate nearly two points higher than the official rate! The National Statistics Bureau (NSB) conducts sample surveys and uses these to estimate the country's GDP and growth rate. The results have invariably disagreed with provincial figures. In 1995, the GDP growth rate suggested by provincial data averaged

three percentage points higher than the figure of 10.5 percent produced by sample surveys. Opinions vary as regards the accuracy of the central government's estimates. However, in China, few scholars publicly attempt any detailed justification of alternative figures because of political sensitivity.

- China's NSB also lacks the capacity to collect data outside normal information channels and lower-level officials interfere with its surveys. The numbers generated by provincial governments remain an important criterion in evaluating local officials' performance, creating an incentive for statistical falsification. The pressure to exaggerate statistics grew in the late 1990s as Chinese officials sought to pump up the economy to stave off the Asian economic slump's effects. Beijing declared that the country had to grow at least 7 percent a year to create jobs and to forestall social unrest. Not surprisingly, reported growth rates have not dipped below that level since.
- Officials may also routinely underreport other sensitive data such as debt numbers, unemployment or even FDI to avoid tax payments and governmental scrutiny. The central government's methods at ascertaining the validity of data, a process it calls *yasuo shuifen* or "squeezing the water", involves sample surveys, price-index adjustments and plenty of guesswork.
- Technical difficulties, such as staff reductions among statistical analysts, have enhanced errors in data. No comprehensive measures exist for the size of the fast-growing private-business and service sectors or even for what constitutes FDI.
- The Chinese government strictly controls economic and industrial data and even classifies some as state secrets. Routinely, Beijing has overvalued SOEs' stocks of unsold goods, and underestimated inflation. Other provinces underreport growth and activity: for example, Zhejiang province in Eastern China may have underreported growth to conceal the rapid development of private companies in its economy. Additionally, affluent provinces, such as Guangdong in Southern China, may have underreported growth to avoid paying more taxes to the central government. However, without more systematic data, economists cannot definitively state if these factors pushed up growth or even if growth occurred.
- Governmental officials downplay unemployment figures to mask the suffering that economic reforms and restructuring have caused. The official unemployment rate of 3.6 percent in 2001 excluded *xiagang* workers (laborers receiving small, monthly stipends from former companies and not counted as unemployed) that economists estimate to number about 10 million. The official rate also excluded farmers who left their fields to work in cities, a floating population of around 150 million unemployed migrants. Using international standards, China's unemployment rate in 2001 approximated 7.6 percent in rural areas and more than 8.5 percent in the cities, well above Beijing's red-flagged figure to indicate inevitable social turmoil.
- Most disturbingly, the central government's debt numbers look highly erroneous. The Central Bank's governor, Dai Xianlong, confessed to Parliament in April 2002 that national domestic debt appeared much higher than the official numbers (16 percent of GDP) suggested. Dai said the figure appeared closer to 60 percent of GDP if one considered unfunded state-pensions' liabilities, local governments' debts, and major banks' nonperforming loans (NPLs). Dai's unusual candor may mask more bad news. Independent economists have discovered that Dai's statistics drew on China's yearbook GDP growth statistics. Debt more realistically appears closer to 100 or 125 percent of GDP. The Bank of China reported two different figures for its NPLs in 1999, one using Chinese accounting standards, another Western; the latter looms 2.6 times greater than the former. Moody's has openly called the books of China's "Big Four" banks, "meaningless"

Subsidies for the 11th Five-Year Program Period

I anticipate that all the subsidies that I identified will continue. The 11th 5-year plan specifically identifies certain strategically important industries that will receive state subsidies. These include

1. Integrated circuits and software including technology for 90-nanometer and smaller integrated circuits
2. New-generation networks including digital TV networks and mobile communication
3. Advanced computing including technology for petaflop computer systems
4. Biomedicine including commercial production of vaccines
5. Civil airplane including general purpose planes and helicopters

6. Satellite applications including meteorological, oceanographic, navigation positioning and telecommunication satellites
7. New materials including high-performance materials in information biological and aerospace industries

Researchers may have more difficulties monitoring the rate of subsidization as China's 11th Five-Year Plan has only two numeric targets: per capita GDP in 2010 must be double the 2000 figure and "each work unit must cut its use of energy by 20 percent of current levels by 2010". The plan fails to mention raising the price of electricity and gasoline, and unlike the previous ten years, sets no economic growth targets.

Governmental Policies Behind Subsidies

Our research has shown that despite recent deregulation efforts, state consumption through its SOEs dominates the Chinese economy. Figure 1 indicates difference in state domination of the Indian and Chinese economies. Subsidies permeate SOEs and well-connected private companies but do not extend to the bulk of private companies.

The subsidies appear huge. According to a World Bank study, 51 percent of all SOEs are losing money. Average current assets had risen to 319 days of annual sales, suggesting that most of the SOEs' assets lay in uncollectible bills or unsaleable inventory. In short, most SOEs were illiquid and massive injections of government money kept them alive.

The state offers subsidies to specific sectors and across sectors. Generally, SOEs and well-connected private companies with strong government network connections can access subsidies. The state is more likely to offer subsidies to private companies that promote strategic development efforts. The 11th Five-Year Plan identifies the following foci for development:

1. Advanced computing.
2. Internet.
3. Programming.
4. Environmental services & resource conservation.
5. Energy production and reserves.
6. Value-chain positioning of Chinese manufacturing.
7. Space, satellite and space-launch related capabilities.

The state grants subsidies to companies that export, as well as to those that serve the domestic markets. Political rather than primarily economic considerations guide policies on subsidies. For example, many provincial governments offer subsidies as rewards to those that successfully manipulate government and business networks.

SOE reforms and strategic goals also shape policies on subsidies. However, for China's leadership, SOE reforms do not include concerns about profits or privatization. The reforms do not have as their goal reducing the state's control over key sectors of the economy, but rather making that control more effective. Consequently, the policies aim to make SOEs efficient and big enough to have a strong international presence such as the FIEs do. Specifically, the Chinese government wants its own global stars. The SASAC, which oversees SOEs, has the mandate to transform 30–50 SOEs into globally competitive national champions by 2010. These include PetroChina, ChinaMobile, Sinopec, CNOOC, Baosteel, China Aluminum, Shanghai Auto, Lenovo, TCL, and Qingdao Haier. Korea's chaebol, rather than Japan's keiretsu provide the guiding model for China's policy on industrial subsidies: through subsidies, the state helps the national champions to diversify their range of businesses and to link more closely to the state.

Some of the policies on subsidies stem from long and mid-range strategic plans; others derive from emergent planning and mistakes. For example, responding to the massive NPLs accumulated by Chinese banks in the 1990s, the government ordered they reduce their NPL ratios—bad loans as a proportion of total loans. However, this policy had unintended consequences. China's banks are technically insolvent but enjoy high liquidity. To cut NPL ratios, the banks merely increased the denominator of the ratios: their loans. Lending rose rapidly, driving growth as a side effect as NPL ratios fell from 28 per cent in 2002 to 13.2 percent at the end of 2004. Assisting the process were transfers of old NPLs, made before the recent credit drive, to newly minted asset management companies (AMCs). The largest banks shifted an initial \$169 billion in 1999–2000 and another \$50 billion last year. The AMCs have become dumping grounds not just for commercial banks' NPLs but also for the assets of failed investment conglomerates, securities businesses and government-infrastructure projects. The state makes the AMCs issue interest-bearing bonds for which it refuses to accept explicit liability. Separately, Beijing has raided tens of billions of dollars of foreign exchange reserves to shore up banks' capital.

Policies regarding subsidies become difficult to unravel as the Chinese state encompasses central and local governments, with competing and often conflicting agendas, and different bureaucratic and political factions at the national level. Subsidies and the policies behind them reflect this fragmentation and conflict. Thousands of warring units that cohabit under the umbrella of the Chinese state control the SOEs. Consequently, SOEs enjoy direct subsidies stemming from state directives and elicit varying degrees of support.

AVIC, the national aerospace group, provides a good example of subsidies to an SOE serving a domestic market. Urged by Deng Xiaoping in 1985, AVIC had designed a civil airliner from scratch in less than 5 years. However, it only built two planes and even China's nationalized airlines refused to buy them. Two decades later, AVIC has received several tax breaks to build a small regional jet but has no idea of its commercial prospects.

Generally, despite stated policies, outsiders cannot ascertain the true policies that underlie subsidies. A secretive and authoritarian organization with unclear aims, closed to scrutiny and debate, controls the Chinese state. More effectively placed subsidies appear in the SOEs that the Beijing central government has classified as global champions. However, recent examples illustrate their complexity. CNOOC, whose \$19 billion bid for Unocal touched off volcanic reactions, is a Hong Kong-listed firm 70 per cent owned by an unlisted parent company, all of whose shares are owned by the central government agency, SASAC. Beijing has helped CNOOC to acquire contracts to control foreign-energy reserves and the company heavily relies on subsidized finance from SASAC. Local governments control other SOEs. These include white goods maker Haier (owned by the Qingdao city government), which launched an unsuccessful bid for Maytag, and the municipally owned Shanghai and Nanjing car companies that have spent the last several months picking through MG Rover. These companies also receive subsidies in line with Beijing's stated goals of creating state-owned multinationals and retaining domestic control over key sectors, such as car making. The demands of both the central government, which sets industry policy, and their local government overlords, whose interests may conflict with Beijing's industrial-policy goals, shape the subsidies the SOEs receive, as well as the SOEs' evolution, strategies and policies. Huawei, a maker of telecoms-network equipment, illustrates a third level of policies and subsidies. Huawei is ostensibly privately owned, although many of its shares are owned by the local state telecoms authorities to whom it has sold equipment. It enjoys a \$10 billion low-interest credit line from the China Development Bank, whose mission is to make concessional loans in support of the state's policy goals. Huawei also has strong ties to China's military.

Profitability of FIEs in China

Few FIEs disclose the real performance of their Chinese operations. Most estimates have relied instead on business surveys and anecdotes. Our research reveals that only about one-third of the foreign companies operating in China have ever made a profit there, and profits have been concentrated in the hands of a few companies. In addition, historically, foreign affiliates in China have lower profit margins than their global average.

Despite some profitable FIEs, the trends on profitability have not changed substantially since China's entry into the WTO. For example, in 1998, a survey of 229 FIEs by management consultants A. T. Kearney showed that only 38 percent of all manufacturers were covering their operating costs. If the companies had included their borrowing costs, or costs of capital, fewer still could have claimed to have broken even.

Another study done at the Chinese Academy of International Trade and Economic Cooperation showed that about one-third of the 354,000 foreign companies operating in China in 2001 turned a profit. Yet, a 1999 survey by the American Chamber of Commerce in China showed that, while 58 percent of its member companies had lower profit margins there than in other global operations, 88 percent had plans to expand. Deloitte & Touche's survey in 2002 confirmed that 90 percent of foreign-owned companies in China planned to expand their operations within the next three years. In 2003, about 424,196 foreign companies, big and small, operated in China (MOFTEC). Michael Furst, Executive Director of the American Chamber of Commerce, Beijing, informed us that about two-thirds of its member companies were making some profits but not up to anticipated levels, while about one-third were making losses. These figures correspond to those from 2004.

A 2004 survey by China Economic Quarterly shows that the earnings of U.S. affiliates in China, which includes the affiliates' profits, and earnings booked through Hong Kong and Singapore, rose to \$4.4 billion. When all other sources of profit are added—including royalty and licensing fees and income from private services—these

affiliates earned \$8.2 billion in 2004. However, U.S. companies made \$7.1 billion in Australia, a market of only 19 million. They earned \$8.9 billion in Taiwan and South Korea, emerging economies with a combined population of 70 million and earned \$14.3 billion in Mexico. Most respondents could not achieve profit margins above their global average.

A large proportion of the earnings end up with a small number of foreign companies that enjoy lucky breaks in China's heavily regulated operating environment. For example, Mobile Telecommunications encountered no vested interests in China and contributed about half of the U.S. companies' mainland-reported earnings as recently as 2001. However, from 2002, Chinese companies, subsidized by the state, moved into mobile handsets and their cutthroat pricing destroyed profits in that sector.

More recently, a consumer loan boom financed by state-run banks underwrote an explosion in car sales that dropped later like a brick—but Volkswagen, the market leader, still earned \$1.2 billion in China in 2003.

Five U.S. companies, including three car makers, accounted for one third of equity profits that mainland affiliates reported. General Motors alone booked \$437 million in earnings. Fast-food companies Yum Brands—owner of KFC—and McDonald's topped off the list. Fast-food companies have consistently made profits in the Chinese domestic economy. They face no competition from state interests and, as services, are less prone to intellectual property abuses. Yum Brands, which has 1,200 restaurants in China, and McDonald's, probably earned about \$200 million and the U.S. car companies in excess of \$500m—equivalent to about one-third of mainland equity income of \$2.4 billion. These figures underline how small China's domestic markets may be.

The exaggerated economic data can have significant effects on perceived performance and projected performance of FDI in China. The successful companies in our research did not rely on economic and industrial data. As Elmar Stachels, Managing Director of Bayer China Company, Ltd., told us “You manage by objectives, objectives that must be clearly stated—then determine what kind of tools you can use to determine if you achieved them, but stick with your objectives. However if it comes to financial figures, it will be challenging. What good will numbers be if the base rates used for comparison of performance are not reliable.”

China remains embroiled in overcapacity and excess production as state investment and subsidies move across sectors, and companies' profits correspondingly whipsaw. A year ago in the auto sector, sales growth for many car models dropped from three digits to less than zero in a few months. In steel, China flipped from a massive net importer to a net exporter in less than a year. In the past nine months, the global price of ethylene—a base constituent of plastics—dropped by half as Chinese production capacity expanded 35 per cent this year and will probably double in the next few years. Soon, smelted copper will join the ranks: China has 2.5 million tons of annual production capacity and another 2.5 million tons under construction. Similarly, in stainless steel, China's annual production capacity approximated 2.5 million tons at the end of 2004. Industrial projects and subsidies will expand this to 10 million tons in five years.

Thank you again for providing me with this opportunity to present some of my research on subsidies in China and effects on competitive environments.

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Statement of National Electrical Manufacturers Association

Thank you for this opportunity to submit the following comments. In recent years China has become the #3 export market and trading partner for our industry (after Mexico and Canada), and three years ago NEMA opened an office in Beijing with the assistance of the Commerce Department's Market Development Cooperator Program. The office has become a valuable resource for our members, providing assistance on a wide variety of China-related matters including energy efficiency, intellectual property rights protection, market access, standards and certification.

Product counterfeiting is a major public safety and trade issue for our industry. China in particular needs to keep on strengthening its anti-counterfeiting measures and enforcement. As we have stressed at the U.S. Ambassador's roundtables on this topic in Beijing and on several other occasions, the U.S. electrical industry has fundamental, ongoing concerns about intellectual property protections in the People's Republic. NEMA members are all too often victimized there by repeated, vast trademark infringement and piracy.

With regards to potentially "subsidized" product coming into the U.S, some of our members have observed competition from extremely low-priced Chinese electrical imports. Since the goods in question are frequently not labor-intensively produced, these member companies are concerned that the Chinese government may be subsidizing the purchase of raw materials and/or providing them below cost via state-owned enterprises. As you know, the Office of the U.S. Trade Representative has just announced its intention to pursue a WTO case pertaining to Chinese export subsidies, and we will be working with USTR as it develops its approach.

NEMA is the trade association of choice for the North American electrical manufacturing industry, including the subsidiaries of many European-based corporations. Domestic production of electrical products sold worldwide exceeds \$120 billion. Founded in 1926 and headquartered near Washington, D.C., its 430 member companies manufacture products used in the generation, transmission and distribution, control, and use of electricity. These products are used in utility, medical, industrial, commercial, institutional, and residential applications. In addition to its headquarters in Rosslyn, Virginia, USA, NEMA also has offices in Beijing, Sao Paulo, and Mexico City.

Thank you for your consideration of these remarks.

NEMA CALLS FOR RENEWAL OF TRADE PROMOTION AUTHORITY

ROSSLYN, VA, February 12, 2007—The National Electrical Manufacturers Association (NEMA) applauds U.S. Trade Representative Susan Schwab's call today for the renewal of President Bush's Trade Promotion Authority (TPA), which, barring Congressional action, is currently scheduled to expire on July 1. NEMA seeks the reciprocal opening of foreign markets through the elimination of tariff and non-tariff barriers for electrical equipment worldwide. Without the TPA, the U.S. government's ability to negotiate new free trade agreements, thereby opening foreign markets to U.S. exports, becomes significantly more difficult.

"Free trade is key to the economic growth of our industry," said Evan Gaddis, NEMA president and chief executive officer. "As economies around the world grow, our members want the electrical equipment they make to be used in new and developing infrastructures. With our own domestic market already largely open, free trade agreements serve to level the trading field for U.S. manufacturers."

NEMA cited several rationales for U.S. negotiators to pursue all avenues for advancing free trade in electrical goods—bilateral, regional, or multinational:

- Since the inception of the North American Free Trade Agreement, Mexico has surged ahead of Canada to become the largest export market and trading partner for NEMA members.
- Since the elimination of many countries' medical equipment tariffs under the last World Trade Organization negotiating round, U.S. electro-medical equipment exports to many countries have soared.
- Since Beijing's entry into the World Trade Organization, China has quickly risen to become the third largest export market and trading partner for NEMA members.
- Since implementation of the U.S. free trade agreements with Chile and Australia in 2003, electrical equipment exports to these countries have risen by 78 percent and 44 percent respectively.
- Improving U.S. competitiveness through, for example, tort and tax reform—rather than opposing free trade—is the best way to sustain U.S. manufacturing.
- Addressing and enhancing the effectiveness of the Trade Adjustment Assistance program should be considered in the context of the TPA debate.
- Labor and environmental provisions in the TPA should be weighed carefully because they can serve to undermine the overall benefits of international economic integration.

NEMA is the trade association of choice for the electrical manufacturing industry. Founded in 1926 and headquartered near Washington, D.C., its approximately 450 member companies manufacture products used in the generation, transmission and distribution, control, and end-use of electricity. These products are used in utility, medical imaging, industrial, commercial, institutional, and residential applications.

Domestic production of electrical products sold worldwide exceeds \$120 billion. In addition to its headquarters in Rosslyn, Virginia, NEMA also has offices in Beijing, São Paulo, and Mexico City.

Statement of Stewart and Stewart

Introduction

The protection of intellectual property rights (IPR) through adequate laws and enforcement is one of the most serious and persistent bilateral issues facing the U.S. and China. Although it is generally conceded that China has revised its IP laws and improved its IP legislative regime so as to comply with the WTO TRIPS Agreement and other international IPR agreements, it is also generally acknowledged that China's performance in enforcing IP rights has been far short of adequate.

The rate of intellectual property piracy and counterfeiting in China remains extremely high. The problem has been, and continues to be, endemic. "In July 2003, the State Council's Development Research Centre estimated that the market value of counterfeit goods in China was between U.S.\$19 billion and U.S.\$24 billion."¹ The World Customs Organization estimates that global counterfeiting exceeds \$500 billion annually and that most of that originates in China.² The financial impact of Chinese IP piracy and counterfeiting on U.S. businesses has been tremendously costly. In its 2004 WTO compliance report, USTR estimated that U.S. businesses lost between \$2.5–\$3.8 billion annually due to piracy of copyrighted materials alone.³

Compliance with Legal Regime Requirements of the WTO TRIPS Agreement

The general consensus is that China has largely complied with its TRIPS commitments as far as establishing a compliant IPR legal framework. Before WTO accession, China amended, revised, and improved its framework of IPR laws, including copyright, trademark and patent laws, so as to be in compliance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement).⁴ After accession, China agreed that it would adhere to the provisions of the TRIPS Agreement, that is, China agreed to abide by internationally-accepted norms regarding protection and enforcement of the intellectual property rights of foreign companies and individuals (including the U.S.) in China.⁵ Among the assumed obligations of the WTO TRIPS Agreement, China agreed to:

- set minimum standards of protection for copyrights and neighboring rights, trademarks, geographical indications, industrial designs, patents, integrated-circuit layout designs and undisclosed information;
- set minimum standards for the enforcement of intellectual property rights in administrative and civil actions;
- set minimum standards, with regard to copyright piracy and trademark counterfeiting, for the enforcement of intellectual property rights in criminal actions and actions at the border; and
- provide other WTO Members national and MFN treatment with respect to protection and enforcement of intellectual property rights.

In general, as noted by the U.S. Trade Representative's Office in its 2005 WTO compliance report, China has largely done a satisfactory job with respect to amending its IPR laws to comply with the TRIPS Agreement and bringing its laws into

¹Trade Policy Review, Report by the Secretariat, WT/TPR/S/161 (28 February 2006) at para. 303.

²See Fakes!, Business Week, February 7, 2005.

³It is estimated that global trade in fake goods amounts to between 3% and 9% of total world trade. Studies by the OECD in 1998 and the International Chamber of Commerce in 1997 estimated that counterfeit goods made up 5–7% of world trade. See *Enforcement of Intellectual Property Rights*, Communication from the European Communities, IP/C/W/448 (9 June 2005) at fn. 1.

⁴*Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at paras. 251–252.

⁵See generally *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at paras. 251–305 (regarding China's intellectual property rights commitments).

line with international norms in most key areas although USTR notes that some improvements (e.g., Internet copyright protection) are still needed.⁶

The WTO recently conducted its first Trade Policy Review (TPR) of China. The WTO Secretariat's TPR report provides an objective overview regarding China's IPR regime. The report notes that China made major revisions to its IPR laws in recent years, including the Patent Law (2000), the Trademark Law (2001), and the Copyright law (2001), and established an "extensive and complex framework" to administer and enforce IPR.⁷ The report describes the basic provisions of these and other IPR laws in China, and notes the importance of IPR to China's own development because "protection of intellectual property rights is essential for ensuring the continued inflow of FDI and the associated transfer of newly developed technologies, as well as fostering the development of new technologies and services in China over the longer term."⁸ Moreover, the report indicates that as China "makes an effort to upgrade obsolete technologies and move production into higher value added sectors, it recognizes that there is a need to improve legislation on intellectual property rights as well as enforcement, in order to attract private sector investment in new and high technologies."⁹

WTO Secretariat Report Notes Continuing High Levels of IPR Infringement and Inadequate IPR Enforcement in China

Notwithstanding China's efforts to enact IPR laws that comply with its TRIPS obligations, the rate of IPR infringement continues to be high and the level of enforcement of IPR continues to be inadequate. The TRIPS Agreement requires China to implement effective enforcement procedures and to provide civil and criminal remedies that have a deterrent effect.¹⁰ China's efforts in the area of IPR enforcement have fallen short of its commitments. The Secretariat's TPR report states:

The main problems identified by China's major trading partners include: lack of coordination among the main enforcement agencies; local protectionism and corruption; inadequate deterrence provided by the system of administrative, civil, and criminal penalties; and a lack of sufficient training of personnel.¹¹

The Secretariat's report notes that enforcement of IPR in China is "complex with a large number of responsible authorities."¹² In China, intellectual property rights may generally be enforced by two means: first, administrative actions which consist of mediation by the authorities, and second, judicial measures through the courts, which include civil actions and criminal prosecutions.¹³ Under China's criminal law, seven types of IPR infringement are crimes: counterfeiting registered trademarks (Article 213); selling goods bearing counterfeited registered trademarks (Article 214); illegally producing and selling representations of registered trademarks (Article 215); forging another person's patent (Article 216); copyright infringement (Article 217); selling infringing reproductions (Article 218); and infringing commercial secrets (Article 219).¹⁴

Enforcement of IPR at the border is governed by Customs regulations and administered by China Customs. Different enforcement procedures apply depending on whether the IPR has been filed or recorded at Customs beforehand. If recorded, "Customs can seize the goods at the border and inform the right-holder in writing

⁶See USTR, 2005 Report to Congress on China's WTO Compliance (December 11, 2005) at 63.

⁷Trade Policy Review: China, Report by the Secretariat, WT/TPR/S/161 (28 February 2006) at para. 272.

⁸*Id.*

⁹*Id.* at para. 302.

¹⁰In particular, TRIPS articles 41 (general obligations) and 61 (criminal procedures) mandate effective enforcement of IPR.

¹¹*Id.* at para. 303.

¹²*Id.* at para. 304. The "responsible authorities" are: "the SIPO for patents and layout designs of integrated circuits; the SAIC and its Trademark Office for trademarks and, along with the AQSIQ, for geographical indications registration and administration; the National Copyright Administration for copyright; the State Drug Administration for protected medicines; MOFCOM (previously the State Economic and Trade Commission) for administrative protection of agriculture-related chemicals; and the Ministry of Agriculture and the State Forestry Administration for the protection of new plant varieties. Enforcement at the border is carried out by Customs, while the SAIC is in charge of enforcement of laws against unfair competition, including the protection of trade secrets. In addition, other government agencies such as the State Press and Publication Administration and the Ministry of Public Security are also involved in enforcement." *Id.*

¹³*Id.* at para. 305.

¹⁴*Id.* at para. 308.

if it is found that the goods infringe the holder's IPRs."¹⁵ In this case, the "right-holder must provide an application letter requesting that the goods be detained, along with a guarantee, within three days of receipt of the notice from Customs."¹⁶ If the IPR is not recorded, then the right-holder must apply to Customs with specified documentation.¹⁷ The Secretariat's report notes that Customs has been increasingly active in seizures and investigations of infringing goods, the number of investigated cases rising from 330 in 2001 to 569 in 2002, 756 in 2003 and 1,051 in 2004.¹⁸

Despite China's IPR enforcement efforts, the Secretariat concludes that a high level of IPR infringement continues and IPR enforcement efforts to date have been inadequate.

Despite these efforts, it appears that enforcement remains weak and infringement of intellectual property rights widespread. In addition to inadequate deterrents provided through the prosecution system, it is also claimed that "local protectionism" is a major cause of IPR infringement. Local protectionism may be the result of discretionary actions that give preference to local traders and producers, and of local corruption, which may provide local manufacturers or traders of counterfeit goods advance notice of police raids; there is also concern that regional administrative agencies lack sufficient knowledge and training in IPR enforcement.¹⁹

American Businesses in China Continue to Face High Levels of IPR Infringement

The American Chamber of Commerce in China (AmCham) recently issued its 2006 White Paper in which it, *inter alia*, provides an overview of the IPR experience of American businesses in China. In short, AmCham finds that there has not been any notable improvement in the IPR environment in China.

Five years after China's accession to the WTO, American businesses confronting IPR enforcement issues in China are shifting their focus from the symptomatic to the systematic. Across industries, American companies have concluded that the returns on case-by-case adjudication (whether through administrative, civil or criminal channels) are insufficient to change the overall environment, and confidence in existing IPR enforcement mechanisms remains low: a consensus is emerging that reform is necessary at the most fundamental level.²⁰

The White Paper reports that 55 percent of American companies surveyed were "negatively affected by IPR violations" and that 41 percent said that "counterfeits of their products increased."²¹ With respect to IPR enforcement, AmCham reports that "generally speaking, administrative enforcement is ineffective."²² Among AmCham's findings:

In administrative actions, only 51% of surveyed companies were satisfied with the degree of cooperation from Chinese officials;

System of transferring administrative cases to criminal courts does not operate smoothly;

In court actions, less than half of surveyed companies were satisfied with the degree of cooperation from Chinese court officials;

Despite lowered thresholds for criminal liability, overall criminal prosecution remained low;

Only 22% of surveyed companies believe the 2004 Judicial Interpretation of Threshold for Criminal Liability will benefit IPR protection either moderately or greatly;

IPR enforcement in civil courts is hampered because the "gathering evidence is difficult; damages amounts are too low; and judgments are problematic to enforce."²³

Notwithstanding these less-than-optimistic findings, AmCham reports that "(n)onetheless, American businesses generally agree that awareness of IPR issues has increased in China and that the Chinese government is making efforts in this area such as in the formation of the Leading Group that has been coordinating the Chinese government's IPR campaign."²⁴

¹⁵ *Id.* at para. 310.

¹⁶ *Id.* at para. 310.

¹⁷ *Id.* at para. 311.

¹⁸ *Id.* at para. 311.

¹⁹ *Id.* at para. 313.

²⁰ AmCham, White Paper 2006: American Business in China (2006) at 34; available at <http://www.amcham-china.org.cn/amcham/show/content.php?Id=1570&menuid=&submid=>.

²¹ *Id.*

²² *Id.* at 36.

²³ *Id.*

²⁴ *Id.* at 34.

USTR's 2006 Special 301 Report

In April 2006, the U.S. Trade Representative's Office issued its annual "Special 301" report concerning the adequacy and effectiveness of intellectual property rights protection provided U.S. trading partners. The report identifies China as a top IPR enforcement priority.²⁵ Given its recentness, the Special 301 report highlights the current status of U.S.-China relations concerning IPR problems. The report concretely summarizes the problem:

China does not provide American copyright materials, inventions, brands, and trade secrets the intellectual property protection and enforcement to which they are entitled. China therefore remains a top intellectual property enforcement priority.²⁶

USTR suggests that a failure to achieve adequate progress in improving IPR enforcement will lead to a WTO dispute settlement case:

Faced with only limited progress by China in addressing certain deficiencies in IPR protection and enforcement, the United States will step up consideration of its WTO dispute settlement options.²⁷

The Special 301 report concludes that despite China's efforts to battle piracy and despite increasing IPR court cases, "overall piracy and counterfeiting levels in China remained unacceptably high in 2005" and affected a wide range of products, brands and technologies.²⁸ USTR found that:

estimated levels of piracy "across all lines of copyright business" are 85–93%; IPR infringing products from China made up 69% of all imported goods seized by U.S. Customs at the U.S. border in 2005, an increase from 63% in 2004; some counterfeit products from China are potential threats to the health and safety of U.S. consumers (e.g., pharmaceuticals, batteries, auto parts, industrial equipment, toys, etc.);

3in addition to consumers and right holders, China itself is directly affected by counterfeiting in lost taxes (e.g., it is estimated that China failed to collect \$3.2–4 billion in 2002 due to counterfeiting).²⁹

Inadequate, ineffective IPR enforcement by China continues to be a major failing. In general, USTR pointed out that "enforcement efforts, particularly at the local level, are hampered by poor coordination among Chinese Government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting criminal cases, lack of training, and inadequate and non-transparent processes."³⁰ In particular, USTR noted that "China suffers from chronic over-reliance on toothless administrative enforcement and underutilization of criminal remedies."³¹ As evidence, USTR cited China's own 2004 data showing that more than 99% of copyright and trademark cases were handled by administrative systems and less than 1% of cases were handled by the police. In effect, because administrative fines are too low to be a deterrent to infringement, potential fines from trademark and copyright piracy in China have become merely costs of doing business. Although China agreed in 2005 to increase the number of criminal IPR actions relative to administrative proceedings, USTR reports no discernible relative increase as of yet.³²

²⁵ See USTR, 2006 Special 301 Report (April 28, 2006).

²⁶ See USTR, 2006 Special 301 Report (April 28, 2006).

²⁷ See USTR, 2006 Special 301 Report (April 28, 2006).

²⁸ See USTR, 2006 Special 301 Report (April 28, 2006). Industries affected by IPR piracy include "films, music and sound recordings, publishing, business and entertainment software, pharmaceuticals, chemicals, information technology, apparel, athletic footwear, textile fabrics and floor coverings, consumer goods, electrical equipment, automotive parts and industrial products, among many others." *Id.*

²⁹ See USTR, 2006 Special 301 Report (April 28, 2006).

³⁰ See USTR, 2006 Special 301 Report (April 28, 2006).

³¹ See USTR, 2006 Special 301 Report (April 28, 2006).

³² For example, USTR states: "According to Chinese data provided in response to U.S. requests, China initiated no copyright retail cases under Article 218 of its Criminal Law in 2004 and six cases in 2005. Under Article 217 of the same law, covering copyright reproduction and distribution, the number of cases initiated rose from 13 to 28. China's self-reported numbers of trademark counterfeiting cases initiated also rose from 53 to 98 under Article 215 (sale of counterfeit trademark goods); from 163 to 221 under Article 213 (manufacture of counterfeit trademark goods), and from 100 to 134 under Article 215 (manufacture of counterfeit trademark labels)." *Id.* Moreover, USTR notes that China's State Administration for Industry and Commerce (SAIC) "recently indicated that the number of trademark cases transferred to the police during 2005 was expected to be less than 0.3% of the total." *Id.*

Statistics for 2001–2004 regarding the transfer of administrative cases to the courts are reported in the WTO Secretariat's Trade Policy Review report, WT/TPR/S/161, at 154 (Table III.18).

	2001	2002	2003	2004
Copyright				
Number of disputes	4,420	6,408	23,013	9,691
Number transferred to court	66	136	224	n/a
Trademarks				
Number of disputes	41,163	39,105	37,489	51,851
Number transferred to court	86	59	45	96

Among the most egregious continuing problems in IPR enforcement, USTR identifies the following issues:

Implementation of China's December 2004 Judicial Interpretation on thresholds for criminal liability. Although this interpretation lowered the thresholds for criminal liability (*i.e.*, minimum values/volumes required to initiate criminal prosecution), they are still too high and, in USTR's view, "a major reason for the lack of an effective criminal deterrent."³³

Valuation of infringing products. To determine whether infringing products meet the threshold for criminal liability, China uses the value of the infringing products, rather than the value of the genuine goods. This method highly undervalues the infringing goods and effectively provides a "safe harbor" to infringers.³⁴

Customs enforcement procedures. Certain provisions of China's customs regulations fail to support border enforcement and, in fact, appear to impose burdens on the IP right holder. These include:

- the provision allowing right holders only 3 days to apply for seizure of suspected infringing goods held by China customs;³⁵
- the provision regarding disposal of seized goods that appears to require public auction, rather than destruction, of infringing goods that are not purchased by the right holder or used for public welfare.³⁶

Civil enforcement deficiencies. USTR notes that it "continues to hear complaints of a lack of consistent, uniform and fair enforcement of China's IPR laws and regulations in the civil courts. Litigants have found that most judges lack necessary technical training, court rules regarding evidence, expert witnesses, and protection of confidential information are vague or ineffective, and the costs of investigation and bringing cases are prohibitively high. In the patent area, where civil enforcement is of particular importance, the process is inefficient and unpredictable. A single case can take four to seven years to complete."³⁷

Other notable deficiencies in China's enforcement of IPR identified by USTR include: "profit motive requirement in copyright cases"; "requirement of identical

³³ See USTR, 2006 Special 301 Report (April 28, 2006).

³⁴ See USTR, 2006 Special 301 Report (April 28, 2006).

³⁵ See USTR, 2006 Special 301 Report (April 28, 2006). Article 16 of China's Regulations of the People's Republic of China on Customs Protection of Intellectual Property Rights states:

Where discovering any import or export goods suspected of infringing an intellectual property right under Customs recordation, the Customs shall immediately notify the holder of the intellectual property right in writing of such suspected infringement. In case the holder of the intellectual property right presents an application in conformity with the provisions of Article 13 of these Regulations and provide a security in conformity with the provisions of Article 14 of these Regulations *within three working days* from the date of service of the notification, the Customs shall detain the suspected infringing goods, notify the holder of the intellectual property right in writing of such detention and serve a Customs Detention Receipt on the consignee or consignor. *The Customs shall not detain the goods in case the holder of the intellectual property right fails to present an application or to provide a security within the period.* (emphasis added)

³⁶ See USTR, 2006 Special 301 Report (April 28, 2006). Article 27 of China's Regulations of the People's Republic of China on Customs Protection of Intellectual Property Rights states:

The suspected infringing goods under detention shall be confiscated by the Customs where such goods are considered to have infringed an intellectual property right by the Customs after investigation.

After confiscating the goods infringing an intellectual property right, the Customs shall notify the holder of the intellectual property right in writing of the information related to the goods of infringement.

Where the confiscated goods infringing an intellectual property right can be used for *public welfare projects*, the Customs shall hand such goods over to the relevant public welfare bodies for use in public welfare projects; where the holder of the intellectual property right intends to purchase the goods, the Customs may have such goods assigned to the holder of the intellectual property right with compensation. Where either the confiscated goods infringing an intellectual property right can not be used for public welfare projects or the holder of the intellectual property right has no intention to purchase the goods, the *Customs may have such goods auctioned* according to law after removing their infringing features; where the infringing features can not be removed, the Customs shall destroy the goods. (emphasis added)

³⁷ See USTR, 2006 Special 301 Report (April 28, 2006).

trademarks in counterfeiting cases”; “lack of criminal liability for certain acts of copyright infringement”; and “need to establish minimum, proportional sentences and clear standards for initiation of police investigations in cases where there is a reasonable suspicion of criminal activity.”³⁸

China’s Efforts to Improve its IPR Regime Have Shown Incremental Improvements

While the problems of high IPR infringement and inadequate IPR enforcement in China are serious and continuing, it must also be acknowledged that China has expended great efforts to address the problems and, although it has not yet achieved an acceptable level of IPR enforcement, it has made some progress toward that goal.

In the WTO’s Trade Policy Review of China, the Chinese Government submitted a report that, *inter alia*, describes the steps it has taken to establish its intellectual property rights regime. China believes that it has worked strenuously to comply with its WTO TRIPS obligations and, despite less-than-perfect results, has worked hard to strengthen and improve enforcement of IPR.³⁹ In sum, China states:

China has made significant progress in IPR protection particularly in building the IPR-related legal system and raising the consciousness of the general public for IPR protection. However, the Chinese Government is fully aware that like in all other countries the protection of intellectual property rights is constrained by the level of economic development and other conditions in reality. IPR protection in China cannot be perfected overnight. The Chinese Government is determined to continue its persistent and strenuous efforts to achieve that goal.⁴⁰

USTR also has noted that there have been some “bright spots in the areas of enforcement.”⁴¹ For example, it finds that China’s “Mountain Eagle” campaign against trademark infringement crimes has actually increased arrests and seizures of infringing goods. In addition, USTR is “encouraged” by (1) China’s recent amendments to rules governing transfer of administrative and customs cases to criminal authorities, (2) the willingness of Chinese authorities on their own to “take *ex officio*” enforcement action on behalf of U.S. right holders without the need for a complaint” (e.g., in Shanghai), and (3) by initial enforcement actions against Internet piracy in 2005.⁴²

Other notable actions taken by China that are intended to help improve IPR education and enforcement include the following.

China’s 2006 Action Plan on IPR Protection

China has issued a comprehensive and aggressive plan to address the whole range of IPR issues. China summarizes the coverage of the Action Plan as follows:

“The Action Plan covers 4 major areas: trademark, copyright, patent and import and export, which involve the IPR protection plans and arrangements of 11 departments including the Ministry of Public Security, Ministry of Information Industry, Ministry of Commerce, Ministry of Culture, Customs General Administration, State Administration of Industry and Commerce, Administration of Quality Inspection, Supervision and Quarantine, Copyright Bureau, State Food and Drug Administration, State Intellectual Property Office, and Legislative Affairs Office of the State Council.

“The Action Plan covers 9 areas: legislation, law enforcement, mechanism building, propaganda, training and education, international communication and cooperation, promoting business self discipline, services to right holders, and subject research.

“In line with the Action Plan, in 2006 China will draft, formulate and revise 17 laws, regulations, rules and measures relating to trademark, copyright, patent and customs protection, and draft, improve and revise 6 judicial interpretations.

“The IPR law enforcement efforts will include 7 dedicated campaigns such as the “Mountain Eagle”, “Sunshine” and “Blue Sky”, 8 regular enforcement initiatives and 20 specific measures.

“The government is going to establish a long standing mechanism constituting 11 parts, including a service center for reporting and complaining IPR violations and publicizing law enforcement statistics, and 18 specific measures. 7 approaches and 39 measures will be adopted to raise the general public’s awareness of IPR protection.

³⁸ See USTR, 2006 Special 301 Report (April 28, 2006).

³⁹ Trade Policy Review: China, Report by the People’s Republic of China, WT/TPR/G/161 (17 March 2006) at paras. 56–66.

⁴⁰ Trade Policy Review: China, Report by the People’s Republic of China, WT/TPR/G/161 (17 March 2006) at para. 66.

⁴¹ See USTR, 2006 Special 301 Report (April 28, 2006).

⁴² See USTR, 2006 Special 301 Report (April 28, 2006).

“Twenty one IPR training programs will be organized under the Project of Training Thousands of IPR Personnel.

“The focus of IPR related international exchanges and cooperation will be on legislation, trade mark, copyright, patent and customs protection, which will be facilitated through 19 exchange and cooperation activities, out of which 7 will be between China and the U.S.

“With a view to improving enterprises’ consciousness and awareness of IPR protection, 3 initiatives will be launched, including the convening of a conference on enterprises’ IPR protection and proprietary innovation.

“Twelve specific measures covering 9 areas will be put in place to better serve the right holders. Besides, countermeasure oriented research will be conducted in 5 fields to strengthen IPR protection.”⁴³

New China IPR Website

Recently, China’s Ministry of Commerce (MOC) announced the launch of an intellectual property rights protection website—www.ipr.gov.cn. The MOC described its purpose as to introduce domestic and overseas readers to China’s laws, rules, policies and measures concerning IPR protection and to enhance public awareness of IPR.⁴⁴ The website provides one-stop access to IPR-related news, policies, documents, laws and regulations, information about IPR legal proceedings, and government ministries involved in IPR administration and enforcement.

Increasing Public Education and Awareness of IPR

From April 16–23, 2006, an “Achievement Exhibition on China’s IPR Protection” was jointly-sponsored by numerous Chinese ministries.⁴⁵ In conjunction with the exhibition, China also held a “China High-level Forum on Intellectual Property Rights Protection 2006.”⁴⁶ In addition, China’s Ministry of Commerce announced in April 2006 that it intends to set up special service centers in 50 cities to handle domestic complaints regarding IPR infringement and provide IPR-related consulting services in order to raise public awareness of IPR protection.⁴⁷

IPR Ombudsman

The Chinese government appointed, effective January 2006, an Intellectual Property Rights Ombudsman at the Chinese Embassy in Washington, DC. The role of the Ombudsman is to serve as the point of contact for U.S. companies, particularly small- and medium-sized businesses, respecting IPR issues in China.

China’s gradual improvement in IPR enforcement is also reflected in the year-to-year increasing number of seizures of IPR infringing goods by China Customs.

China Customs IPR Seizures (2001–2005)

Cases	330	573	756	1,051	1,210
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Source: China Customs

⁴³ http://www.ipr.gov.cn/ipr/en/info/Article.jsp?a_no=3326&col_no=102&dir=200604.

⁴⁴ See Xinhua, *China launches IPR protection website*, People’s Daily Online (April 30, 2006); http://english.people.com.cn/200604/30/eng20060430_262285.html

⁴⁵ Sponsors of the exhibition included the following: State Council, the National Office of Rectification and Standardization of Market Economic Order, the Propaganda Department of the CPC Central Committee, Ministry of Public Security, Ministry of Commerce, Ministry of Culture, State-owned Assets Supervision and Administration Commission of the State Council, General Administration of Customs, State Administration for Industry and Commerce, National Copyright Administration, State Intellectual Property Office, and Information Office of the State Council.

⁴⁶ This exhibition “was the first large-scale exhibition held in China with the content of IPR protection.” Chinese Premier Wen Jiabao said that the exhibition showed the “Chinese government’s determination to fight piracy.” The Chinese government described the exhibition as follows:

This exhibition had three areas including Department Area, Local Area, and Enterprise Area. Department Area mainly displayed a general description of IPR, trademark right protection, patent right protection, copyright protection, customs protection of IPR, and judicial protection of IPR in other related fields; Local Area mainly introduced the progress in the Special Campaigns of IPR Protection in 15 key localities and the fruitful results of local enterprises’ independent innovation and fighting for their rights; Enterprise Area focused on the following contents: Chinese enterprises’ enhancement of IPR protection awareness, competition under the IPR system, emphasis on the development and innovation of own intellectual property, creation of independent brands, promotion of the popularity and international competitiveness etc.

See *Achievement Exhibition on China’s IPR Protection 2006* (May 8, 2006); available at http://www.ipr.gov.cn/ipr/en/info/Article.jsp?a_no=4077&col_no=115&dir=200605.

⁴⁷ *IPR infringement complaints to go to special service centers*, China View (April 11, 2006); http://news.xinhuanet.com/english/2006-04/11/content_4411135.htm.

In 2005, of the total 1,210 IPR seizures by China Customs, 51 (4.2%) were of imports, and 1,159 (98.4%) were of exports.

Of course, when evaluating China's IPR enforcement performance, one should be mindful of the many practical problems that can impede efficient enforcement. For example, in the case of border IPR enforcement by China Customs, the level of performance will be affected by the number of trained personnel available and assigned to the task of inspection in the same way that the availability (or lack thereof) of U.S. Customs personnel would affect border enforcement in the US. Another consideration is that China Customs can only inspect a limited percentage of containers, and, statistically, China Customs finds containers without IPR problems 3 times more often than it finds problem containers. Given these facts, local Chinese customs officials may be reluctant to delay suspected infringing goods because of the likelihood that the goods will ultimately be found non-infringing and such a delay will affect the market.

In addition to actions by the Chinese government, there have been some noteworthy victories in cases brought by IP right holders. Two recent examples are:

Ruling against Silk Alley market landlords. Trademark owners of five luxury goods brands (Prada, Chanel, Louis Vuitton, Gucci, and Burberry) filed civil claims in mid-2005 against the landlord, Beijing Xiushui Haosen Clothing Co. Ltd., for allowing merchants to sell knock-offs on its premises. In December 2005, the Beijing No. 2 Intermediate People's Court's found for the trademark holders, and in April 2006, the Beijing High People's Court upheld the previous ruling.⁴⁸

Pfizer's Viagra patent upheld. In 2004, China's patent review board found in favor of Chinese generic drug makers who had challenged Pfizer's patent on sildenafil citrate, the main component of Viagra. In June 2006, the Beijing No. 1 Intermediate Court overturned the patent review board's decision and upheld Pfizer's patent.⁴⁹

Moreover, as Jiang Zhipei, Chief Judge of the Property Rights Tribunal of the Chinese Supreme People's Court, has observed: "Domestic companies are the real impetus for improving IPR."⁵⁰ Thus, improvement in the level of IPR protection and enforcement in China is likely to increase to the extent that Chinese companies recognize the importance of and need for effective IPR protection to their own operations, as they increasingly innovate to compete in the market.

Though long and arduous the process might be, China will not make any discount on the principles and goals on its IPR Protection, said Yan Xiaohong, deputy chief of the National Copyright Administration of China at a seminar on encouraging self-innovation and advocating the use of authentic software.

If we do not protect IPR, we could not realize the goal of building an innovation-oriented nation. China will continue to improve legislation and law enforcement in IPR protection to create a sound market environment for enterprises, said Yan.⁵¹

AmCham agrees that innovation by Chinese companies will be an important driver toward improved IPR protection in the future. AmCham states in its 2006 White Paper:

Vigorous IPR enforcement is obviously a baseline condition necessary for innovation to flourish.⁵²

Successful realization of its innovation priorities is the upside inducement for the Chinese to implement the fundamental reforms necessary to guarantee protection of IPR.⁵³

In addition, in the future, the activities of industry groups and associations may become an important means to improve IPR enforcement in China. For example, it is my understanding that the China Trademark Association (CTA) (www.cta.org.cn), a group composed of enterprises, trademark agencies and trademark experts, provides its members various services such as consulting, research, seminars and training, trademark monitoring, and serving as a communications link between its mem-

⁴⁸See, e.g., *Luxury brands win trademark lawsuit*, China Daily (April 19, 2006); http://www.chinadaily.com.cn/home/2006-04/19/content_571000.htm.

⁴⁹See, e.g., *China court upholds Pfizer's Viagra patent*, BusinessWeek Online (June 5, 2006) (<http://www.businessweek.com/ap/financialnews/D81TG680.htm?sub=apn+home+down&chan=db>); *Pfizer wins patent protection for Viagra in China*, China Daily (June 4, 2006) (http://www.chinadaily.net/china/2006-06/04/content_607962.htm).

⁵⁰Chris Buckley, *On piracy, an advocate for China's progress*, International Herald Tribune (May 1, 2006); <http://www.ihb.com/articles/2005/10/04/business/IPRjudge.php>.

⁵¹No discount in IPR protection, copyright watchdog, People's Daily Online (May 12, 2006) (emphasis added); http://english.people.com.cn/200605/12/eng20060512_265097.html.

⁵²AmCham, White Paper 2006: American Business in China (2006) at 34.

⁵³AmCham, White Paper 2006: American Business in China (2006) at 42.

bers and government agencies. To the extent that U.S. companies operating in China become members of CTA and other similar groups, it is likely to enhance the development and improvement of the IPR protection system in China.

In sum, China is making gradual and incremental progress in developing a more effective IPR protection and enforcement system, but chronic, intractable problems remain. The question is—how fast China can or will be able to move toward a level of IPR protection and enforcement that is acceptable to its trading partners.

JCCT—The Primary Forum for U.S.-China Bilateral Negotiations on IPR

Since 1994, the main vehicle for U.S.-China bilateral dialogue regarding IPR issues has been the annual meeting of the Joint Commission on Commerce and Trade (JCCT). At the April 2004 JCCT meeting, the U.S. and China made IPR issues one of their highest trade priorities. At the meetings in 2004, 2005, and 2006, China committed to undertake various actions to reduce IPR infringement and improve IPR enforcement. In some cases, China has fulfilled its commitment and, in some other instances, China is continuing its efforts toward completing the commitment.⁵⁴ USTR's Special 301 report cites the following examples of China implementing IPR-related commitments made at the 2004 and 2005 JCCT meetings:

“At the 2006 JCCT China reaffirmed its commitment, made at previous JCCT meetings, to continue efforts to ensure use of legalized software at all levels of government, and to adopt procedures to ensure that enterprises use legal software, beginning with large enterprises and state-owned enterprises.”

“China recently fulfilled a 2005 JCCT commitment by adopting amended rules governing the transfer of administrative and customs cases to criminal authorities, and has taken some steps to pursue administrative actions against end-user software piracy.”

“China recently posted an IPR ombudsman to its Embassy in Washington, who has facilitated contacts between U.S. government officials and their counterparts in Beijing, and been a source of information for U.S. businesses, including small and medium-size companies.”

“China has also sought to expand enforcement cooperation as agreed at the 2004 and 2005 JCCT meetings.” In particular, China's General Administration of Customs (GAC) and the U.S. Customs and Border Protection (CBP) are developing a plan under which “CBP will cooperate with GAC to affect a four-part customs co-operation program aimed at improving administrative IPR border enforcement in both countries,” including such elements as data sharing, exchange of statistical information on IPR border seizures, establishing a contact for matters related to IPR-infringing goods, and technical exchanges (e.g., legislative/regulatory improvements, risk modeling and IPR recordation administration).

“China is also taking steps to meet its 2005 JCCT commitment to submit a legislative package to the National People's Congress in June 2006 for China to join the WIPO Internet Treaties.”⁵⁵

The recently completed 2006 JCCT resulted in the following outcomes on requests made by the U.S. aimed toward improving enforcement of intellectual property rights:

In support of its commitment to significantly reduce intellectual property rights (IPR) infringement levels, China agreed to the following specific actions.

- *Pirated Optical Disks (ODs)*. The Chinese government has taken action against 14 factories producing illegal optical disks and has pledged to step up enforcement in this important area to combat copyright piracy of films, music, and software. China and the U.S. will also explore new ways to strengthen cooperation in this area.
- *Requirements to Install Legitimate Software*. The Chinese government has issued a notice requiring the pre-loading of legal operating system software on all computers produced or imported into China, as well as a notice requiring government agencies to purchase computers with pre-loaded software. In line with these requirements, several Chinese computer manufacturers have recently signed agreements to purchase U.S. operating system software.
- *Ensuring Use of Legal Software in Government and Enterprises*. In addition to ongoing efforts to ensure use of legalized software at all levels of the government, China has launched efforts to ensure the legalization of software used in Chinese enterprises. In addition, China has agreed to discuss U.S. proposals re-

⁵⁴The U.S.-China Business Council has prepared a useful summary of China's 2004, 2005, and 2006 JCCT commitments, with an indication of their current status. See <http://www.uschina.org/public/documents/2006/05/jcct-commitments.pdf>.

⁵⁵See USTR, 2006 Special 301 Report (April 28, 2006).

garding government and enterprise software asset management in the JCCT IPR Working Group.

- Rid Consumer Markets of Infringing Goods. The Chinese government has agreed to intensify its efforts to ensure that public markets in China are free of infringing products and has announced enforcement actions in several major cities.
- Individual Cases. The Chinese government agreed to help ensure that individual IPR cases raised by the U.S. government with China will be vigorously pursued.
- Action Plan: China has announced a broad action plan to improve enforcement of IP rights, including steps in the areas of enforcement, legislation and education. Strongly implemented, these steps could lead to significant improvement in the IP situation in China.⁵⁶

Potential for a WTO Dispute Settlement Case re IPR Enforcement

In its 2005 report to Congress, the Commission stated that “China’s principal IPR deficiency is effective enforcement of its laws, which is among its WTO commitments.”⁵⁷ The Commission further observed that “China’s failure to protect IPR is clearly within the jurisdiction of the WTO, given China’s explicit obligations under the TRIPS agreement,” and then recommended that, “(b)ecause China is not making satisfactory progress in this area, the United States should initiate action through the dispute resolution process at the WTO to address China’s failure to comply with both the criminal penalties and enforcement provisions of TRIPS.”⁵⁸

In its recently-issued Special 301 report, USTR said it was “stepping up consideration” of WTO dispute settlement options against China with regard to IPR issues. In doing so, USTR did not identify the grounds for any potential WTO complaint. However, a recent press report states that USTR is considering a WTO case on the issue of thresholds for IPR criminal liability.

The U.S. Trade Representative’s office last week indicated that it is getting closer to launching a WTO challenge against China’s laws that require certain thresholds to be met before intellectual property rights violators can be hit with criminal penalties.

Informed sources have said since March that USTR is looking at a case that attacks these thresholds, and industry sources this week agreed that the new Special 301 report officially declares that these thresholds are a serious problem.⁵⁹

With respect to the basis for a TRIPS-based complaint, in general, the TRIPS Agreement obligates Members to:

provide minimum standards of protection for copyrights and neighboring rights, trademarks, geographical indications, industrial designs, patents, integrated-circuit layout designs and undisclosed information; establish minimum standards for IPR enforcement in administrative and civil actions and, respecting copyright piracy and trademark counterfeiting, in criminal actions and actions at the border. TRIPS requires that enforcement procedures have a deterrent effect; and provide national and MFN treatment with respect to the protection and enforcement of intellectual property rights.

A number of interested party groups, in focusing on China’s inadequate IPR enforcement, have recommended bringing a WTO case against China based on alleged violations of TRIPS Article 41 (which sets out the general obligations re enforcement of IPR) and/or Article 61 (dealing with criminal enforcement procedures). The following is a representative sampling of such potential claims.

RIAA (testimony of Jay Berman to House W&M Committee, April 14, 2005):

⁵⁶The U.S.-China Joint Commission on Commerce and Trade (JCCT), Outcomes on U.S. Requests (April 11, 2006); http://www.ita.doc.gov/press/press_releases/2006/jcct_outcomes_041106.pdf.

⁵⁷2005 Report to Congress of the U.S.-China Economic and Security Review Commission, 109th Cong., 1st Sess. (November 2005) at 47 (citing TRIPS article 41.1: “Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement, including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements. These procedures shall be applied in such a manner as to avoid the creation of barriers to legitimate trade and to provide for safeguards against their abuse.”).

⁵⁸2005 Report to Congress of the U.S.-China Economic and Security Review Commission, 109th Cong., 1st Sess. (November 2005) at 48.

⁵⁹USTR Hints at WTO Case Against China on IPR Criminal Thresholds, Inside U.S.-China Trade (May 3, 2006).

TRIPS Article 41 states that “members shall ensure that enforcement procedures—are available under their law so as to permit effective actions against any infringement—covered by this Agreement, including expeditious remedies—which constitute a deterrent to further infringements.” China’s excessive reliance upon administrative sanctions in the form of the seizure of infringing product and, if the guilty party doesn’t flee, the imposition of small fines, do not deter further infringements.

TRIPS Article 61 specifically requires that criminal penalties “be applied in cases of willful trademark counterfeiting or copyright piracy on a commercial scale.” China has conducted few prosecutions and made very few convictions for copyright piracy. China has persisted in defining “commercial scale” through the use of complicated numerical thresholds and ambiguous definitions which, despite the new Chinese “judicial interpretation” described below, make it highly unlikely any pirate will face criminal penalties.

Moreover, the remedies provided in China’s criminal code are only available in those instances where the pirate is making a profit. The profit test is actually more difficult to meet than the commercial scale requirement. A “profit” test violates the TRIPS Agreement.

NAM (Comments to USTR re Special 301 out-of-cycle review, February 14, 2005):

USTR should begin to prepare a WTO case and seek consultations with China as soon as U.S. trade agencies believe they have assembled sufficient information to take this step.

Such WTO consultations should present the breadth and depth of China’s failure to implement the intellectual property protections as required by the WTO, and should present an assessment of the economic cost to U.S. firms as well as the threat to health and safety posed by tolerating the production and export of counterfeit goods

IPA (Comments to USTR re Special 301 out-of-cycle review, February 9, 2005):

China does not presently meet its WTO/TRIPS commitments on enforcement and particularly Articles 41, 50 and 61 (provide enforcement which “on the ground” deters further infringements, provide effective ex parte civil search orders, and provide specific deterrent criminal penalties).

Intel (Comments to USTR re Special 301 out-of-cycle review, February 14, 2005):

Chinese law’s reliance on numerical thresholds as basis for prosecutions and convictions will continue to create irrational obstacles to criminal enforcement. China’s Criminal Code (especially articles 213–215) appears inconsistent with TRIPS Article 61 which requires access to criminal enforcement in counterfeiting cases on a “commercial scale.”

Moreover, USTR’s Special 301 out-of-cycle Review conducted in 2005 noted some potential bases of TRIPS violations.⁶⁰

“Article 63 of the TRIPS Agreement requires laws, regulations and final judicial decisions and administrative rulings of general application pertaining to IPR infringement be made publicly available to rights holders. Despite this requirement, lack of transparent information on IPR infringement levels and enforcement activities in China continues to be an acute problem.”

“Article 61 of the TRIPS Agreement requires a criminal IPR enforcement system with deterrent effect. Presently, however, criminal enforcement in China has not demonstrated any deterrent effect on infringers.”

“Articles 41 and 61 of the TRIPS Agreement require effective and deterrent IPR enforcement. Consensus exists among rights holders, however, that China’s current IPR system relies too heavily on enforcement by administrative authorities and is non-deterrent.”

“China has yet to implement any meaningful data protections for pharmaceutical products, as required by Article 39.1 of the TRIPS Agreement.”

In considering how to approach a potential WTO case, it would likely be easier to succeed on specific allegations of TRIPS violations as applied in China, in con-

⁶⁰ See http://www.ustr.gov/assets/Document_Library/Reports_Publications/2005/2005_Special_301/asset_upload_file835_7647.pdf.

trast to alleging generally that China's IPR laws violate TRIPS obligations. A more general approach might, however, if successful, produce a broader effect. Under WTO jurisprudence, it is not uncommon for Members to allege that an underlying law "as such" may violate a WTO legal obligation or otherwise nullify or impair benefits under the covered agreements, independent of any application of that law.

At the WTO, there have been nine TRIPS disputes that have resulted in panel reports. Six disputes have focused on specific aspects of IPR laws and regulations rather than on IPR enforcement per se. These cases and the TRIPS articles cited are:

India—Patents (U.S.), WT/DS50 (Articles 27, 63, 70.8 and 70.9)

Indonesia—Autos, WT/DS54 (Articles 3, 20 and 65)

India—Patents (EC), WT/DS79 (Article 70.8(a) and 70.9)

Canada—Pharmaceutical Patents, WT/DS114 (Articles 27, 30, 33 and 70)

U.S.—Section 110(5) Copyright Act, WT/DS160 (Articles 9.1 and 13)

Canada—Patent Term, WT/DS170 (Articles 33, 62.1, 62.4, 65, 70.1 and 70.2)

Article 41 sets out the general obligation that Members ensure that enforcement procedures are available "so as to permit effective action against any act of infringement of intellectual property rights" covered by TRIPS, "including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements." Article 42 requires Members to provide fair and equitable civil judicial procedures concerning the enforcement of any intellectual property right covered by the TRIPS agreement. While Article 42 is included in Section III of TRIPS (covering enforcement of IPR), it is focused on procedures, not the general obligation of Article 41 to provide effective IPR enforcement.

Three TRIPS disputes that resulted in panel and/or appellate body reports have cited violations of TRIPS enforcement Articles 41 and/or 42, but in none of these cases did the panel or appellate body find a violation. They are:

EC—Trademarks and Geographical Indications (U.S.), WT/DS/174 (Articles 1, 2, 3, 4, 16, 22, 41, 42, and 65)

- The U.S. claimed that the EC's regulation was inconsistent with Articles 41.1, 41.2, 41.4, 42 and 44.1 of the TRIPS Agreement because it denied the owner of a registered trademark the right provided for in Article 16.1 of the TRIPS Agreement, and because it did not, with respect to a GI, provide the rights provided for in Article 22.2 of the TRIPS Agreement. The U.S. requested a finding that the enforcement obligations of the TRIPS Agreement applied to the EC regulation to the extent that it made unavailable to right holders the requisite enforcement procedures and remedies.⁶¹ However, the Panel exercised "judicial economy" with respect to these claims and did not address them.⁶²

EC—Trademarks and Geographical Indications (Australia), WT/DS/290 (Articles 1, 2, 3, 4, 16, 22, 24, 41, 42, and 65)

- Australia argued that the EC failed to ensure that enforcement procedures as specified in Part III of the TRIPS Agreement are available under its law, contrary to Article 41.1 of the TRIPS Agreement, as a consequence of, inter alia, the fact that the EC regulation did not grant the Consultative Committee the authority required by Articles 43, 44, 45, 46 and 48 of the TRIPS Agreement, and did not provide judicial authorities with the authority required by Articles 43, 44, 45, 46, 48 and 49. The Panel, however, ruled that Australia's inclusion of claims under Articles 43, 44, 45, 48, and 49 in conjunction with Article 41 were not included in its original claim and therefore were outside the Panel's terms of reference.⁶³

U.S.—Section 211 Appropriations Act, WT/DS/176 (Articles 2, 3, 4, 15, 16, 42)

- The Panel found Section 211(a)(2) to be inconsistent with Article 42 of the TRIPS Agreement but the Appellate Body reversed the Panel's finding.⁶⁴

⁶¹ See Report of the Panel, *EC—Trademarks and Geographical Indications* (U.S.), WT/DS174/R (15 March 2005) at para. 7.759.

⁶² See Report of the Panel, *EC—Trademarks and Geographical Indications* (U.S.), WT/DS174/R (15 March 2005) at para. 8.2.

⁶³ See Report of the Panel, *EC—Trademarks and Geographical Indications* (Australia), WT/DS290/R (15 March 2005) at paras. 7.44, 7.49.

⁶⁴ See Report of the Panel, *United States—Section 211 Omnibus Appropriations Act of 1998*, WT/DS176/R (6 August 2001) at para. 8.102; Report of the Appellate Body, *United States—Section 211 Omnibus Appropriations Act of 1998*, WT/DS176/AB/R (2 January 2002) at para. 231.

Although, in each of these cases, neither the panel nor appellate body directly addressed a claim of a TRIPS violation based on Article 41 alone and its obligation of “effective” IPR enforcement, it is interesting to note their tangential comments regarding the scope of Article 41.⁶⁵

In addition to the cases above, the U.S. filed two other sets of WTO dispute settlement cases respecting IPR enforcement, but they were resolved by mutual agreement without going to a panel. They are:

Denmark—Measures Affecting the Enforcement of IPR, WT/DS83

Sweden—Measures Affecting the Enforcement of IPR, WT/DS86

- U.S. alleged that Denmark & Sweden failed to make provisional measures available in the context of civil proceedings involving IPR, and this violated TRIPS Articles 50, 63 and 65

EC—Enforcement of IPR for Motion Pictures and Television Programs, WT/DS124

Greece—Enforcement of IPR for Motion Pictures and Television Programs, WT/DS125

- U.S. claimed that a significant number of TV stations in Greece regularly broadcast copyrighted motion pictures and television programs without the authorization of copyright owners.
- U.S. contended that effective remedies against copyright infringement did not appear to be provided or enforced in Greece in respect of these broadcasts.
- U.S. alleged a violation of Articles 41 and 61 of the TRIPS Agreement.

In sum, as asserted by various companies, interest groups, and the USTR, there are multiple potential grounds for alleging TRIPS violations by China, whether focused on deficiencies in China’s IPR laws “as such” or on specific cases of inadequate and ineffective IPR enforcement. The case against copyright infringement of movies and TV programs in Greece provides a prior example of a specific IPR case. There are many specific instances in China of inadequate enforcement of its IPR laws, such as the issue of criminal liability thresholds being too low to be a deterrent to infringement, to which this example could be applied. Alternatively, a potential case could be based on the claim that specific aspects of China’s IPR laws “as such” violate its TRIPS obligations and have resulted in nullification or impairment of benefits to the U.S. A determination of the best approach would likely depend on the amount and quality of specific evidence of TRIPS violations available, as well

⁶⁵ Report of the Panel, United States—Section 211 Omnibus Appropriations Act of 1998, WT/DS176/R (6 August 2001):

8.97 In interpreting Article 42, we look next at its context. The Article appears in Section 2 of Part III of the TRIPS Agreement, which deals with the enforcement of intellectual property rights. The inclusion of this Part on enforcement in the TRIPS Agreement was one of the major accomplishments of the Uruguay Round negotiations as it expanded the scope of enforcement aspect of intellectual property rights. Prior to the TRIPS Agreement, provisions related to enforcement were limited to general obligations to provide legal remedies and seizure of infringing goods. Article 41 of Section 1 of Part III lays down the general obligations applicable to all enforcement measures. It provides, *inter alia*, that “Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement” (paragraph 1) and that “[p]rocedures concerning the enforcement of intellectual property rights shall be fair and equitable” (paragraph 2). Article 42—together with the other provisions of Section 2 of Part III—elaborates upon the general obligations contained in Section 1 of the same Part in respect of civil and administrative procedures and remedies. As concerns the requirement of effectiveness, the object and purpose of the enforcement provisions of Part III is expressed in the Preamble to the Agreement, which recognizes the need of “the provision of effective and appropriate means for the enforcement of trade-related intellectual property rights”.

Report of the Appellate Body, United States—Section 211 Omnibus Appropriations Act of 1998, WT/DS176/AB/R (2 January 2002):

206. Section 1 of Part III lays out “General Obligations” of Members. According to Article 41.1 of Section 1, Members are required to ensure that enforcement procedures as specified in Part III are available under their domestic law “so as to permit effective action against any act of infringement of intellectual property rights covered by [the TRIPS] Agreement”. These enforcement procedures must include expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements. At the same time, these procedures must be applied in such a manner as to avoid the creation of barriers to legitimate trade and to provide safeguards against their abuse. These procedures provide for an internationally-agreed minimum standard which Members are bound to implement in their domestic legislation.

Report of the Panel, EC—Trademarks and Geographical Indications (Australia), WT/DS290/R (15 March 2005):

7.48 The Panel considers that Article 41.1 imposes an obligation. The language of that provision is expressed in terms of what Members “shall” ensure and is not hortatory. The substance of the provision adds qualitative elements to the procedures specified in Part III through use of terms such as “effective”, “expeditious” and “deterrent” and is not redundant.

as strategic policy decisions as to whether it would more advantageous to take a targeted approach or to focus on achieving as large an effect as possible.⁶⁶

The Way Forward Requires Practical Approaches

The above discussion describes how IPR issues have been playing out. The practical question before us, however, is how the U.S. and China can make real progress in improving IPR protection and enforcement. At this point, based on my past research and presentations to the Commission as well as my experiences in China meeting with government and industry officials, I would like to offer some personal observations on the way forward.

While a WTO case is always a possibility, the U.S. generally tries to work with new Members to provide assistance in achieving their obligations rather than to turn to the dispute settlement path. The ultimate object is an acceptable IPR system in China. It is hoped of course that additional pressure applied to China will lead to greater and better results. But we are at this stage so far from an acceptable situation that it would be useful to look “outside the box” for possible solutions.

First, to the extent China can accomplish “quantum leaps” in IPR improvement by means of government mandate, all the better. Thus, China’s directive regarding use of genuine software on government computers and pre-loading of genuine software on all computers manufactured or imported into China is a positive development.

Second, China can and should make changes to their statutes and regulations to improve and enhance IPR protection and enforcement. Thus, for example, it would be a helpful development if China would revisit the subject of IPR criminal liability and provide real deterrence.

Third, there is a need to reduce the portion of trade that needs to be reviewed or inspected for possible IP violations by Customs here and there. For example, the U.S. and China could look to the programs that U.S. Customs and Border Protection have instituted as models, such as C-TPAT (Customs-Trade Partnership Against Terrorism) program. C-TPAT is a voluntary government-business initiative aimed at strengthening and improving the overall international supply chain and U.S. border security. Among the benefits to those who participate in C-TPAT are reduced number of CBP inspections (therefore, reduced border delay times) and priority processing for CBP inspections. The U.S. and China could apply the same model to their IP trade issues. Thus, they could enlist the private sector to become partners in IP border enforcement. Like C-TPAT, those who participate could benefit from lessened border scrutiny, fewer inspections, and expedited customs processing. The goal of such a program would be to identify IP-compliant importers and their suppliers who would be subject to reduced inspections so that the customs authorities could focus heightened scrutiny on high-risk importers. The cost of increased inspections for high-risk imports could be passed on to the import community, which would allow the government to hire more border inspection resources. The point is that there is a need for innovative programs that will provide an incentive for importers to work with their foreign suppliers to guarantee that the goods they import from China are IP compliant.

⁶⁶In contrast to the dispute settlement path, the EC has made a number of submissions to the WTO TRIPS Council urging the Council to “carefully examine compliance of Members with the enforcement provisions of TRIPS.” See *Enforcement of Intellectual Property Rights*, Communication from the European Communities, IP/C/W/448 (9 June 2005) at para. 3. In particular, the EC said:

19. It is unquestionable that the TRIPS Agreement establishes the freedom of each Member to determine the appropriate method of implementing its provisions. However, ultimately such implementation must allow the adequate prosecution of the objectives of TRIPS.

20. In that respect, the EC would like to recall that, according to Article 41.1 of the TRIPS Agreement, “Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit **effective action** against any act of infringement of intellectual property rights covered by this Agreement, including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements” Hence, we have an obligation to take account of the present situation and find the ways to combat and reduce counterfeiting and piracy.

21. Considering the TRIPS Council assignments, in particular its task to “monitor the operation of this Agreement and, in particular, Members’ compliance with their obligations hereunder” explicitly mentioned in Article 68 TRIPS, there is no doubt that this Council is the appropriate forum to address the issue.

22. In view of the above, the EC submit that the deficient enforcement of IPRs is a major concern that should be carefully considered in the forthcoming months.

Id. at paras. 19–22 (emphasis in original). The EC recently renewed its proposal that the TRIPS Council foster a dialogue among WTO Members with a view to identifying solutions to implementation deficiencies on IPR enforcement. See *Enforcement of Intellectual Property Rights*, Communication from the European Communities, IP/C/W/468 (10 March 2006).

Fourth, there is a gap in IP enforcement rights that needs to be closed through appropriate legislation. Specifically, the U.S. should consider legislation to ensure that companies that buy IPR-protected equipment have some legal ability to reach imported products made on IP-infringing equipment. It is the case that in certain situations, manufacturing equipment protected by intellectual property rights has been misappropriated by foreign equipment manufacturers. Such IPR-infringing equipment has then been used to produce other products which are exported to the U.S. U.S. companies that lawfully use IPR-protected equipment to manufacture similar products are disadvantaged by having to compete with imported products manufactured using IPR-infringing equipment. Currently, this situation is not addressed by U.S. law for the downstream industry. It is critical that U.S. companies lawfully producing products using IPR-protected manufacturing equipment who are forced to compete with producers using IPR-infringing equipment be permitted a legal means to sue the beneficiaries of IP-infringing equipment.

Statement of R. John Theriault, Pfizer, New York, New York

Pfizer is a diversified, global health care company and the world's largest pharmaceutical company. Our core business is the discovery, development and marketing of innovative pharmaceuticals for human and animal health, and we are committed to ensuring the integrity of those products when they reach the market.

We have developed a focused anti-counterfeiting program to protect the integrity of our products and supply chain. Staffing for that program now includes seventeen security professionals, including two based in Hong Kong, one based in Beijing, and one based in Shanghai. Since expanding our presence in China in 2004, we have seen remarkable results, including a steady increase in the number and quality of enforcement actions taken, some of which are discussed in detail below.

In China, we have successfully partnered with the Public Security Bureau (PSB), the Ministry of Public Security (MPS), the State Administration for Industry and Commerce (SAIC), and various provincial offices of both the SAIC and the State Food and Drug Administrations (SFDA) to identify and raid counterfeiters. The partnership is grounded in trust, facilitated by Pfizer's anti-counterfeiting training programs with the Chinese and our sharing of leads. While there is still much room for improvement in regard to the enforcement of Intellectual Property rights in China, the following facts indicate that some progress is being made.

2006 Seizures and Arrests

Recent enforcement actions by Chinese authorities demonstrate the improved protection of Pfizer's intellectual property rights:

- Of the more than 8.9 million counterfeit Pfizer tablets seized globally, more than 4.2 million (47.94%) were seized in China
- Of the 2289 kg of active pharmaceutical ingredient (API) for Pfizer products seized globally, 98.07% (2245 kg) was seized in China
- Of the 506 arrests made globally for IP violations, 113 (22%) were by Chinese authorities
- In response to leads provided to them, the SFDA and local FDAs inspected pharmacies in 50 cities, confiscating counterfeit medicines, imposing stiff financial penalties and, for the most severe violations, closing pharmacies and detaining their owners.
- 78 herbal medicines containing sildenafil citrate, the API for Viagra, were removed from the retail market by Shanghai FDA
- Between February 2006 and February 2007, China Customs made eleven export seizures, totaling 196,484 counterfeit Viagra tablets

Investigation and Case Studies

Overall, our relationship with Chinese authorities has been productive and positive. The following case studies are representative of our recent accomplishments in the region.

International Internet Distribution Network Disrupted (2005)

"Operation Cross Ocean", a joint investigation by MPS and U.S. Immigration and Customs Enforcement (ICE), resulted in Chinese authorities seizing ten lines of manufacturing equipment as well as counterfeit pharmaceuticals valued at \$4.3 million (USD), four printing machines and counterfeit packaging, in what one U.S. Customs official has described as "one of the most significant investigations involving

counterfeit pharmaceuticals.” The network, which relied on the Internet to attract brokers and customers, included hundreds of brokers in the U.S. and EU and, based on records seized, appeared to have been in operation for at least two years. Chinese authorities arrested the ringleader, David Wang aka Li Wenhui, and at least 10 others; U.S. authorities arrested one of Li’s U.S. brokers.

Between August 27 and September 1, Chinese authorities executed two raids. In the first, which took place in Tianjin, they seized 230,000 counterfeit ED tablets, including 130,000 counterfeit Viagra, and arrested the ringleader, David Wang. In the second, they raided a factory in Zheng Zhou City, which was identified as Li’s source. Authorities, who made an additional 10 to 12 arrests, have provided preliminary reports of the seizure of 10 lines of manufacturing/packaging equipment, 400,000 counterfeit Viagra tablets, 200 kg of sildenafil citrate (enough for approximately 1.4 million 100mg tablets), and an undisclosed quantity of counterfeit Lipitor. Based on business records that were also seized, it would appear that the network has been in operation for at least two years.

Raids Net Almost Two Million Counterfeit Tablests (2005)

The January 2005 raids by the MPS were credited by authorities as one of China’s best cases under the “Mountain Eagle” campaign designed to capture IP violators and pursue criminal charges. The raids, which were coordinated in three cities and included a licensed and very successful pharmaceutical factory in Guangdong, China, netted almost 2 million counterfeit Pfizer tablets—1,000,000 Lipitor; 499,200 Norvasc; and 446,400 Viagra—as well as production equipment including punches and dies for Pfizer products.

200 Officers Mobilized for Raids (20060)

An investigation referred by Pfizer to PSB Guangdong resulted in the seizure of more than 10.7 million counterfeit tablets from various pharmaceutical companies, including 1.14 million Viagra and 100 kg sildenafil, enough to manufacture 700,000 100mg tablets. Through our investigation, we had identified Cao Ming as a major manufacturer and international distributor of counterfeit pharmaceuticals. During the joint investigation that followed, one manufacturing site and two warehouses were identified as part of the criminal operation. Authorities mobilized 200 officers to conduct raids at the three locations. In addition to the finished tablets and API, they seized 30 pieces of equipment used to manufacture the counterfeits and made 33 arrests.

Factory in Guangzhou Dismantled (2006)

Based on information we provided, authorities dismantled a factory in Guangzhou, capable of producing 5000 kg of sildenafil citrate a month. The raids, conducted by more than 70 Guangdong Provincial and Guangzhou PSB officers, were the culmination of a year-long investigation conducted by the Chinese authorities. During the raids they conducted, authorities made twelve arrests and seized 1514 kgs sildenafil citrate (Viagra), 7 kgs tadalafil (Cialis), and more than 100 machines used to manufacture the APIs. According to authorities, those operating the factory knowingly sold API to a number of counterfeiters throughout China. We continue to work with authorities to identify those customers.

Harsh Sentences Imposed on IP Violators

In two separate cases, defendants arrested in late 2005 based on information provided by Pfizer received harsh jail sentences.

In the first, Wang WeiPing was sentenced to 10 years in jail and fined approximately \$250,000 following his conviction for the manufacture and sale of counterfeit pharmaceuticals. Wang had been arrested in November 2005 after his factory was raided and approximately 400,000 counterfeit Viagra and 2.4 counterfeit Cialis were seized. This represents the quickest conviction and harshest sentence imposed to date by the Chinese courts.

In the second, four defendants were sentenced to terms ranging from 1 to 8 years for their participation in a criminal network that had, since 2001, sold more than 60,000 kg of sildenafil citrate to counterfeiters.

Other Major Seizures by Chinese Authorities

- January 2005: almost two million counterfeit tablets: 1,000,000 Lipitor; 499,200 Norvasc; and 446,400
- Viagra July 2005: 100,000 counterfeit Viagra tablets + 100 kg API (700,000 100mg tablets) and counterfeit U.S. packaging. Follow up investigation led to raid on printing factory and seizure of more than 80,000 U.S. type bottle labels and patient information

- February 2006: 1,840,000 counterfeit Viagra tablets + 200 kg API (1,400,000 100mg tablets)
- August-September 2006: 87,400 counterfeit Norvasc tablets + 100 kg API (28,840,000 5mg tablets)

CONCERNS

Despite these successes, there are still areas of concern:

Defects in PRC Criminal Code (JI)

“Harmful enough” Standard

Prosecution of cases involving counterfeit medicines remains a concern, since the burden of proof rests with the brand owner. For example, a company can be charged with drug counterfeiting under the current criminal law but unless the illicit product is proven “harmful enough to endanger human health”, it is virtually impossible to initiate a criminal investigation on “drug counterfeiting”. The standard for the legal term “harmful enough” was set by a 2001 Judicial Interpretation on Criminal Cases of Production and Sale of Fake and Inferior Products, which is often too high and impractical for efficient criminal prosecution. (The rationale here is that it is easy for drug counterfeiters to acquire the kind of active ingredient they need from chemical companies or even over the Internet.) The standard for a harmful substance to be “harmful enough to endanger human health” is also both ambiguous and outdated. In addition, we have found that the procedural requirement of acquiring a certificate from a provincial-level, SFDA-designated drug inspection agency as a precondition to initiating criminal investigation presents even more hardship for criminal sanction against drug counterfeiting.

Method of Calculating Value

In December 2004, the Supreme People’s Court disseminated the Judicial Interpretation on Issues Concerning Application of Laws in Handling Criminal Cases Involving the Infringement of Intellectual Property (“New JI”). While Pfizer applauds the positive impact this New JI has had on enforcement by materially reducing the monetary thresholds to trigger criminal IPR prosecutions and giving clarity on some of the key terms of IPR crimes in the Criminal Code, we are still concerned with drawbacks, including methods for calculating the value of infringing products.

Unregulated API: No Criminal Liability

An important factor contributing to the counterfeit drug problem in China is that bulk chemicals with medical uses, broadly available from under-regulated chemical manufacturers, are increasingly becoming the source of APIs used in the production of counterfeit medicines. This view is supported by the easy access that the public has to API products on the Internet and the fact that almost no requirements are imposed on purchases of API products, which can easily be turned into counterfeit drugs by the purchasers. Pfizer favors strengthening China’s regulations relating to the manufacture and sale of bulk chemicals having medical use and the creation of an SFDA-led inter-ministerial task force to investigate and supervise the manufacture and sale of API substance labeled as “chemical products”.

Especially relevant to the pharmaceutical industry, is that supplying API in bulk form may not be subject to criminal liability for IPR infringement under either the Criminal Code or the New JI.

Statement of United States Chamber of Commerce

The U.S. Chamber believes that the economic and commercial relationship remains at the core of broader bilateral engagement with China. This core must be nurtured—especially because it provides clear benefits to both countries. China should move to address problems of concern to the U.S. business community; the U.S. Congress and Administration should avoid yielding to the temptations of protectionist policies; and across America, we must ensure that we have policies in place—e.g., on healthcare, education, tax policy, incentives and funding for research and development, etc.—that support our continued status as the world’s most dynamic and innovative economy.

The U.S. Chamber applauds the Department of Treasury and other participating branches of the U.S. government for organizing the constructive Strategic Economic Dialogue (SED) with the Chinese on a range of topics deemed vital to U.S.-China relations. We hope that the SED will improve mutual trust and understanding and lead to improved results for American business as well as serve as a substantive

complement to the Joint Commission on Commerce and Trade (JCCT). The JCCT remains an essential forum for resolving bilateral disputes and securing improvements to the business environment in China for American business. The Chamber will continue to support both dialogues by providing the U.S. government with our membership's priorities and timely analysis of both the challenges and opportunities in our economic and commercial engagement.

Notwithstanding the many challenges in the bilateral commercial relationship, the Chamber underscores that the relationship continues to offer significant benefits and opportunities to U.S. exporters, investors, and the broader U.S. economy. According to recently released statistics, exports to China grew by 32 percent from 2005 to 2006, making it the fastest growing major market for U.S. goods. Since China's accession to the World Trade Organization (WTO) in 2001, U.S. exports to China have grown over 150 percent, five times faster than they have to the rest of the world.

Given the breadth of its membership, the Chamber has seen how the China market has become an integral component in the successes of large multi-nationals and small- and medium-size enterprises (SMEs) alike. Through a number of innovative programs, including our China Business Initiative—the nation's leading, sustained grassroots education program on China business opportunities—the Chamber continues its commitment to expanding export opportunities to China for American SMEs and to ensuring that our member companies have the necessary tools to compete in the China market.

Indeed, despite their challenges accessing the market, SMEs have found China to be a relatively welcoming export market. Of the 21,360 U.S. firms known to have exported merchandise to China in 2004 (the last year for which data are available), 19,201, or 90 percent, were SMEs.

The number of SMEs exporting to China has been rising much faster than the number of large companies. From 1992 to 2004 the number of SMEs exporting to China surged by 511 percent, compared to 128 percent for large-company exporters. Together, SMEs represent 35.1 percent of all known merchandise exports to China—compared with only a 28.6 percent share of U.S. exports to the world as a whole.

These data, among others, underscore the tremendous benefits U.S. companies and workers gain from our economic relationship with China. That said, we emphasize that there needs to be continued and significant progress on critical issues of concern to American business if the bilateral economic and commercial relationship is to endure and deepen.

Specifically, we hope to see timely progress from China in the following areas:

- **Industrial Policies:** Some in the Chinese government and academic circles believe China can spur growth and innovation through government directed industrial policies, including measures that tilt the playing field in favor of Chinese firms. Such policies are bad for China and will lead to significant, increased trade frictions with the United States. China should resolve concerns regarding its domestic and outbound investment and industrial policies in various “strategic” sectors, particularly as many of these sectors—from financial services to autos to telecommunications to energy—remain closed or mostly closed to foreign investment by American companies. Moreover, the Chamber believes that China should refrain from utilizing non-trade laws to impose non-tariff barriers on U.S. products and suppliers. Recently announced initiatives to promote “self-reliant innovation” by decreasing China's use of foreign technologies are worrisome to the Chamber and our members. Of immediate concern to U.S. industry is ensuring that China's evolving competition laws; proposed patent law reforms; proposed standards policies, regulations, and policies; and government procurement regime are non-discriminatory and transparent and fully respect the rights of U.S. inventors and authors.
- **Subsidies:** The Chamber publicly supported the U.S. government's recent action to bring a case in the WTO against China for offering prohibited subsidies for exports and import substitution. We believe that China should provide a much more detailed report to the WTO on its use of subsidies, with particular attention to subsidies of state-owned companies provided through its banking system, provincial government-level subsidization, and the amount of subsidies involved.
- **Currency:** On the currency issue, the Chamber believes that China should move as quickly as possible to a system that allows market forces to determine the exchange rate of the renminbi. Given this goal, we strongly support Treasury Secretary Henry Paulson's efforts in the context of the SED to encourage broader financial sector reforms that will enable China to accelerate its removal

of capital controls and allow market forces to fully determine the value of its currency. The U.S. Chamber also believes that any legislation against China's currency regime that would be inconsistent with the rules of the WTO would be an ineffective and counterproductive tool. Such measures could amount to a steep tax on millions of lower-income American consumers and could engender legitimate Chinese retaliation against U.S. exports to China.

In late March, U.S. Chamber President and CEO Tom Donohue will travel to China for high-level discussions with China's government and business community and to host a global forum on innovation and the protection of intellectual property rights (IPR). The forum is but one example of the U.S. Chamber's continuing commitment and leadership on the global stage to foster multilateral cooperation with governments, member companies, and business associations around the world, including our counterparts in China, to address the serious challenges associated with the counterfeiting, piracy, and patent theft that harm American businesses and the U.S. economy.

During his visit, Mr. Donohue will continue to press the Chinese government to protect and enforce the IPR of American firms operating inside and outside the China marketplace. He will also travel to one or two provinces to promote cooperation in provincial and local efforts to improve protection and enforcement of domestic and foreign intellectual property (IP). The U.S. Chamber continues to work closely with the People's Republic of China (PRC) government and the Chinese business community at all levels of society to develop constructive and effective solutions to outstanding IPR protection and enforcement challenges. These efforts, along with the overarching IPR protection and enforcement challenges, are discussed below.

Intellectual Property Rights

Over the past three years the central government of China has sharply increased its efforts to improve IPR protection in China. Progress has been made in certain areas, although the overall the level of IPR violations in China during 2006 did not improve from previous years and remains at critical levels. Advances within China have been offset to some degree by apparent increases in Chinese exports of counterfeit and pirated goods, facilitated to a great extent by the Internet.

The central government and a number of provincial governments appear committed to dealing more proactively with counterfeiting and copyright piracy going forward, and cooperation with industry and with IPR enforcement authorities in the United States has increased. Significant reductions in the levels of piracy and counterfeiting in the market are, however, the only true measures for determining the fulfillment of these commitments.

Progress and Ongoing Challenges

The Chinese government took important steps between 2004 and early 2006 to improve legislation on IPR protection and at the same time increased the number of criminal cases against trademark counterfeiters. For example, the government reported a 52 percent increase in the number of criminal convictions for IPR offences during 2006. However, the total number of such cases was only 796, and most of these cases appeared to involve local IPR owners, rather than foreign parties. Further, a majority of foreign companies polled in one recent industry survey indicated that counterfeiting in China during 2006 had either remained the same or worsened.

The Chinese government recently reported the results of robust administrative enforcement campaigns undertaken in 2006 to address optical disk and online copyright piracy. Still, American film, music, software, and book publishers report that these campaigns only appeared to reduce the superficial visibility of piracy, and overall losses remained at critical levels during 2006—anywhere between 85 percent and 95 percent for optical disks. Meanwhile, our members report that China is increasingly the preferred location for copyright pirates to establish Internet servers providing access to pirated films and music distributed worldwide.

China's General Administration of Customs meanwhile reported a 100 percent increase in seizure of infringing goods (mainly counterfeits) during 2006, to 2,473, involving goods valued over U.S.\$25 million. This laudable increase in enforcement does not appear, however, to have slowed the overall growth of counterfeit exports from China. The Department of Homeland Security (DHS) disclosed that China (including the Hong Kong SAR) was the source of 87 percent of all infringing items seized at America's borders last year, and the value of seizures from China and Hong Kong almost doubled, to over U.S.\$135 million.

The PRC pledged at the April 2006 JCCT that "IPR trial chambers will be open in courts across China" and that "50 IPR Infringement Reporting Centers will be set up in 50 key cities in China." The Chinese government completed the establish-

ment of these centers in late August 2006, and they may prove useful for IP owners that have in the past been confused as to the correct authority with which to file enforcement complaints. But it remains unclear whether these centers will have other functions, such as the job of intervening when difficulties arise in the course of administrative transfers to judicial authorities or with protectionism. We hope the Chinese government will move to address this issue.

The PRC also announced at the April 2006 JCCT that it had issued a notice requiring the pre-loading of legal operating system software on all computers manufactured in or imported into China as well as a notice requiring government agencies to provide adequate budget for, and the purchase of computers with pre-loaded legal software. In line with these requirements, several Chinese computer manufacturers signed agreements last year to purchase U.S. operating system software. These announcements built upon commitments undertaken by China at the July 2005 JCCT to complete its legalization program designed to ensure that all central, provincial, and local government offices use only licensed software, and to extend this program to enterprises (including state-owned enterprises) in 2006. This is a very positive step.

Moreover, China issued new Internet regulations last year to protect IPR in the digital environment. While helpful, the Chamber has concerns regarding the scope of the rights protected by the new law and vague terminology in the law that could result in significant loopholes. An effective Internet law is critically important given the rapid uptake in broadband in China, the increase in Internet piracy, and the fact that all peer-to-peer web sites streaming broadcast content without authority are headquartered in China.

These commitments underscore the central government's efforts to improve IPR protection and enforcement, and create a basis for optimism that the Chinese government will continue to achieve progress in IPR protection. However, because there has not been a substantial reduction in the scope and depth of the overall IPR problem over the last two years, and to ensure sustainable forward movement in areas where strong commitments have been made, more aggressive actions, especially in the areas of enforcement and transparency, are urgently needed.

The Need for Deeper Reforms and Additional Policy Resources

There are many factors which contribute to ongoing IPR problems in China. Foremost among them is China's lack of sufficient criminal enforcement, and a corresponding lack of resources, training, and awareness at the local level. These are problems which are symptomatic of IPR enforcement in most countries, regardless of their level of development. But the U.S. Chamber and its partner organizations believe that the problems in China are particularly acute given their size and scope. Both the central and local governments can—and must—do better, not only to comply with WTO obligations, but also to promote long-term growth and innovation in China.

Central authorities have also been unable to implement more timely and effective improvements in certain local hot-spot regions across the country, including the Chaoyang District of Beijing (home of the Silk Market), and elsewhere. Local protectionism remains a key barrier to progress, and one which will require greater political commitment in the coming months and years if it is to be overcome.

There are, however, steps proposed by foreign governments, industry and China's own IPR experts that the central government can take in the short- to medium-term which can lead to more progress in the fight against IPR infringements. These include structural changes, including the updating of the PRC Criminal Code, clarification of existing laws and regulations to eliminate loopholes and simplify enforcement procedures, the introduction of greater transparency and information sharing, and other measures.

While the WTO technically renders IPR protection as a "trade issue", we hope the Chinese government recognizes that foreign concerns over China's difficulties in IPR protection are motivated by a good faith desire to promote the rule of law, to stop the growth of organized crime, and to facilitate the growth of a vibrant healthy economy for both Chinese and foreign enterprises equally. We are particularly cognizant and appreciate that China's desire to ascend the value chain and develop an economy based on innovation rather than low-cost manufacturing are driving its new focus on IP.

In this regard, the U.S. Chamber is monitoring closely China's post-WTO accession use of industrial policies—including antitrust law, standard setting, and patent reform—to foster the development of strategic sectors and that could reduce the value of foreign-held IPR. We are closely tracking several different draft laws and regulations that could substantially weaken legal protection for U.S. rights' holders,

and we would be pleased to provide the committee with additional information on this topic.

U.S. Chamber China Intellectual Property Action Plan

The U.S. Chamber is hopeful that more intensified dialogue and research on these structural problems and ongoing legislative changes in China's IPR regime will take place during 2007, in tandem with continued exchanges and training activities undertaken in cooperation with the Chamber's provincial government initiatives.

Beginning in 2004, the U.S. Chamber has attempted to promote change, raise capacity and awareness and strengthen industry and government cooperation on IPR protection in China through a number of its own initiatives. These are summarized below:

(1) Enhancing coordination of policy messages delivered to the U.S. and Chinese governments on China IP concerns.

(2) Providing an overarching, inclusive platform for substantive dialogue on IP-related legal and policy matters between U.S. corporate, legal, and academic IP experts and Chinese government officials at the national, provincial, and local levels.

(3) Establishing new benchmarking initiatives at the national and provincial levels to more accurately monitor the government's performance, including effectiveness in IPR enforcement, and responsiveness to domestic and foreign industry concerns. Just last month, the Chamber signed a memorandum of understanding with the Jiangsu Provincial IP authorities, which includes collaboration on education, training, and benchmarking. The Jiangsu provincial leadership and its IP authorities have demonstrated substantial good will in our engagement, and we are hopeful that we can achieve measurable progress in IP protection and enforcement for both American and Jiangsu companies.

(4) Creating new joint working groups in the provinces to collaboratively identify obstacles in enforcement at the provincial and local level and to generate possible solutions.

(5) Conducting joint enforcement seminars in Guangdong, Jiangsu, and Zhejiang provinces to educate local stakeholders and further research important IP issues. The Chamber has conducted many seminars in China and in the United States since July 2005, and will conduct additional seminars on IPR protection and enforcement in Jiangsu and Guangdong later this year.

In the year ahead, the Chamber will continue to work with all levels of the PRC government with the goal of reducing the level of counterfeiting and piracy of IPR in China. To strengthen IPR protection and enforcement, the Chamber will stimulate expert discussions on a wider range of necessary legal reforms, introduce more international "best practices," and continue efforts to raise awareness. Furthermore, the Chamber plans to expand its program of targeted seminars with provincial authorities and initiate a broader range of cooperative projects both with individual ministries and other U.S., Chinese, and foreign industry associations.

Conclusion

The U.S. Chamber and our members appreciate the opportunity to participate in China's continuing development. We applaud the many cases in which Chinese authorities have worked closely with the U.S. business community to implement WTO commitments as well as to resolve disputes that have arisen during the implementation process. As stated at the outset of this testimony, China is now the fastest-growing trading partner of the United States. Rapidly expanding bilateral economic and commercial ties underscore the market opportunities that China offers to U.S. exporters and investors, which support the creation of high value-added jobs at home.

But China can and must do more. The U.S. business community and others that vigorously advocated China's WTO membership premised their support on expectations that China is evolving into a more open and transparent market based on the rule of law. China's unsuccessful efforts to consistently enforce its IPR laws and to vigorously deter IP theft represent the most visible examples of these expectations remaining unfulfilled.

Similarly, China has continued its reliance on state guidance and industrial policies—capitalization requirements, mandated national technology standards, subsidies, investment restrictions—in key sectors. Not only are such policies a breach of the spirit of China's market access commitments and openness that China embraced when joining the WTO, but they also give credibility to China's critics who doubt China's commitment to create a business environment that values equally the economic contributions of domestic and foreign companies. Thus, the need for both proactive and substantive government efforts remains pressing.

Given the manner in which issues across all aspects of the relationship impact each other, the U.S. Chamber applauded the Department of Treasury and other participating branches of the U.S. government, along with their Chinese counterparts, for organizing the SED. The Chamber has provided input to the U.S. government on priority issues for our membership—including capital markets, industrial policy, IPR, health, energy, and transparency—since the inception of the SED, and we will continue to work with the relevant agencies through the various SED working groups. The Chamber also continues to strongly support the JCCT as an important forum for discussion and resolution of issues of concern, many of which have been touched on in this testimony. The importance of progress on IPR, and the need to address concerns with regard to market access in a number of industries, can not be underestimated.

The Chamber underscores, however, that for all the fits and starts, for the examples of China's sluggish WTO compliance, none of these trumps the value of engaging the world's most populous nation in the rules-based trading system. For all those who care about the future of our economy, jobs for Americans, stability and peace in the world, the protection of global health, and the advancement of environmental quality and human rights, we must continue to encourage China to become an active and committed member of the world trading system. Working within the WTO framework remains the most promising path to progress and is vastly superior to approaches that seek to punish and isolate this emerging global power. Moreover, in demanding that China adhere to the standards of a rules-based trading system, we too must honor those rules and take no action that is illegal under WTO agreements.

Statement of U.S.-China Business Council

Like all World Trade Organization (WTO) members, China is required to provide legal protection against intellectual property infringement and to provide penalties for enforcement that are sufficient to deter future violations. Despite this obligation, inadequate protection for intellectual property continues to impede U.S. companies in China. Respondents to the U.S.-China Business Council's (USCBC) 2006 membership survey ranked intellectual property rights (IPR) enforcement as China's most serious shortfall in implementing its WTO commitments. Though 33 percent of respondents said there had been some improvement in China's IPR enforcement, more than half of survey respondents said there had been no improvement in China's enforcement of IPR in the previous 12 months.

As policymakers consider ways to address China's problems in IPR protection, it is important to keep in mind that "IPR" is a broad term encompassing many distinct areas, including copyrights, trademarks, patents and trade secrets. Companies view the IPR problem differently depending on their industry and the nature of their problem. A motion picture company sees the problem differently from a pharmaceutical company, and both have a different view than an industrial company. The severity of the problem is different for each sector, the policy redress is different, and importantly, the actions companies support are different in each of these areas. Furthermore, for some companies, particularly in the media sectors, IPR problems are aggravated by market-access restrictions that limit the availability of legitimate products to Chinese consumers. In the end, a differentiated approach to the IPR problem in China—one that accounts for the unique problems and solutions in the various areas—is the most productive way to achieve advancement for U.S. companies on this issue.

The ineffectiveness of China's IPR enforcement regime stems in part from China's primary reliance on administrative authorities, which are able to impose only very low penalties to enforce IPR laws, instead of the court system, in which civil suits and criminal prosecutions could impose higher penalties on IPR infringers. PRC courts handled only 385 IPR-related cases in 2004, according to China's 2005 White Paper on IPR. In contrast, local copyright administrations resolved nearly 9,500 copyright infringement cases, local administrations of industry and commerce handled nearly 52,000 trademark violations, and local patent administrations dealt with roughly 10,000 patent infringement cases. While government agencies are generally responsive to the requests of IPR holders to take administrative actions against infringers, the low penalties these government bodies can impose without court authorization serve as only a minimal deterrent to future infringements.

To be fair, China's central government has taken a number of steps in an attempt to address these and other issues that limit the effectiveness of its IPR enforcement.

These steps generally have been in response to the U.S. government's persistent pursuit of improving IPR protection via the Joint Committee on Commerce and Trade (JCCT) process. In March 2006, China's National IPR Working Group, an interagency body under the State Council and chaired by Vice Premier Wu Yi, issued its 2006 IPR Protection Action Plan. Though much of the plan focuses on ways to promote innovation, it also expresses an intention to boost enforcement activities. Most of the plan's provisions are still in the implementation process, so its effectiveness cannot yet be fully determined.

Stemming from the action plan, China's Supreme People's Procuratorate, the Ministry of Public Security (MPS), the Ministry of Supervision, and the Leading Group on National Rectification and Standardization of Market Order jointly issued an opinion in March 2006 to facilitate the transfer of IPR cases from administrative agencies to public security bureaus for criminal investigations. MPS and the General Administration of Customs in March 2006 also jointly issued rules to boost coordination in IPR cases involving products scheduled for export. China has also conducted a handful of special IPR enforcement campaigns in accordance with the action plan. These include Mountain Eagle, aimed at copyright violators; Sunshine, designed to clear cities of pirated recorded materials; and Blue Sky, targeted at individuals who distribute infringing products at trade fairs.

Continuing in China's pattern of taking incremental steps toward an improved IPR environment, the Ministry of Culture issued in November 2006 regulations giving local culture authorities more tools to address piracy of recorded music and cinema products. In December, the Beijing Number One Intermediate Court ruled that Pfizer, Inc.'s patent on the drug Viagra is valid, thereby reversing an early ruling that had revoked the patent and had allowed Chinese producers to legally manufacture what were, in essence, counterfeit pills. Also in December, the PRC National People's Congress approved the World Intellectual Property Organization Copyright Treaty and Performances and Phonograms Treaty, thus meeting a commitment China made at the 2006 session of the JCCT. In early 2007, China's Supreme People's Court issued an opinion that could streamline judicial proceedings on IPR cases and make them more accessible and cost-effective for companies protecting their rights.

These are welcome steps, but China's legal capacity for effectively protecting IPR remains limited. China's use of value thresholds to determine whether IPR infringers face criminal charges reduces the efficacy of Beijing's recent steps to facilitate criminal prosecutions of IPR violators. These thresholds, although lowered in China's Supreme People's Court December 2004 judicial interpretation, provide a loophole for IPR infringers to escape criminal prosecution by, for example, keeping the value of inventory stored at any one location below the threshold level. Moreover, calculations to determine whether the thresholds have been met are based on the price of the counterfeit product rather than that of the legitimate—and higher priced—product it imitates. China's use of numerical value thresholds appears to be inconsistent with its commitments as a signatory of the WTO Agreement on Trade Related Aspects of Intellectual Property (TRIPS), which calls for criminal sanctions in all cases of IPR violations on a "commercial scale." The Supreme People's Court is reviewing its 2004 judicial interpretation as part of the action plan; U.S. officials should press for a TRIPS-consistent application of criminal sanctions on IPR violations.

For its part, USCBC has urged the PRC government to take this course. In numerous meetings in 2006 with Vice Premier Wu Yi and other senior and working-level PRC officials in various agencies, USCBC advocated the abandonment of thresholds and the adoption of the "commercial scale" criteria. USCBC complemented these meetings with a written submission to several PRC government bodies suggesting detailed changes to PRC laws that would provide for an enhanced legal framework for enforcing IPR protection. Those recommendations are attached to this statement. Adopting the "commercial scale" criteria and other changes to its laws governing IPR enforcement would be important steps the PRC government can take to benefit numerous companies in a broad array of sectors.

To fully solve the country's IPR protection problems, China must make improvements in several areas on a sustained basis. China must engage in initiatives such as increasing enforcement resources; training prosecutors and judges in IPR investigations and case law; and educating officials and the public at all levels on how IPR infringement harms China's consumers and the development of its own innovative economy. Greater market access for legitimate products would provide consumers an alternative to pirated products. And, specific revisions to aspects of China's legal code—including the revision of the current thresholds used to determine criminality—are important steps to addressing this top problem faced by U.S. companies in China and, increasingly, in other markets.

RECOMMENDED IMPROVEMENTS TO CHINA'S IPR LAWS AND REGULATIONS

INTERPRETATION BY THE SUPREME PEOPLE'S COURT AND SUPREME PEOPLE'S PROCURATORATE ON SEVERAL ISSUES OF CONCRETE APPLICATION OF LAWS IN HANDLING CRIMINAL CASES INVOLVING INTELLECTUAL PROPERTY

(DECEMBER 22, 2004)	
EXISTING	SUGGESTED MODIFICATION.
The Judicial Interpretation includes thresholds for determining copyright, trademark and patent criminal violations.	Eliminate thresholds for criminal violations, and define criminal violations as infringing activities that occur on a "commercial scale." Revise Criminal Code Articles 214, 217, and 218 accordingly..
Articles 5 and 6 specify that violations must have been made with the purpose of making profits.	Eliminate the requirement that copyright offenders be proven to have acted with profit-making motive. Replace with language that adjudicates cases based on inflicted harm..
No provisions stipulating the treatment of unauthorized rental, broadcast, and exhibition of software, film, sound recordings, and other works.	Confirm that unauthorized rental, broadcast, and exhibition of software, film, sound recordings, and other works may be transferred for criminal prosecution..
N.A.	<i>Suggested additions:</i> .
	Make repeat offenders subject to automatic criminal liability..
	In cases where no sales transaction occurs or no sales records exist, make criminal penalties applicable based on value of inventory, using the victim's price..
	Include presumptions of knowledge for landlords on intellectual property (IP) crimes, including counterfeiting trademarks, pirating copyrighted material, or providing production technology..
	Restrict access for violators to raw materials and other ancillary services like electricity, in accordance with international practice..
	Confirm that criminal liability applies to end-users of infringed software..
PRC CRIMINAL CODE	
EXISTING	SUGGESTED MODIFICATION.
Part I, Chapter 4, Section 1, Article 64 requires that illegally obtained property be recovered or restitution and compensation paid.	Include provision that property used in the commission of a crime shall be confiscated and destroyed..
Part II, Chapter 3, Section 2, Article 214 does not specify that exports constitute a type of sale.	Include the export, rental, and possession of counterfeit trademark goods as types of sale under Article 214..

**INTERPRETATION BY THE SUPREME PEOPLE'S COURT AND
SUPREME PEOPLE'S PROCURATORATE ON SEVERAL ISSUES
OF CONCRETE APPLICATION OF LAWS IN HANDLING CRIMI-
NAL CASES INVOLVING INTELLECTUAL PROPERTY—Contin-
ued**

(DECEMBER 22, 2004)	
Part II, Chapter 3, Section 2, Articles 217 and 218 specify that violators must have acted "for the purpose of reaping profits."	Eliminate the requirement that copyright offenders be proven to have acted with profit-making motive. Replace with requirement that offenders be proven to have inflicted harm..
Part II, Chapter 3, Section 2, Article 218 sets the threshold for the crime of knowingly selling pirated copyright works at RMB 100,000 and sets the threshold for knowingly selling counterfeit trademark goods at RMB 50,000.	Remove all value thresholds for criminalizing trademark and copyright violations and define violations as infringing activities that occur on a "commercial scale."
	Criminalize end use of pirated copyright works or counterfeit trademark goods, including unauthorized rental, broadcast, or exhibition of software, film, sound recordings, or other works..
Part II, Chapter 3, Section 2, Article 219 limits punishment for violating commercial secrets to those who cause "significant loss."	Eliminate "significant loss" threshold for violations..
N.A.	<i>Suggested addition:.</i>
	Subject violators with repeat offenses to stronger penalties..

PRC CRIMINAL PROCEDURE LAW

EXISTING	SUGGESTED MODIFICATION
Part II, Chapter II details the standards for criminal investigations. Article 83 indicates that cases are filed and investigations conducted "upon discovering criminal facts or criminal suspects."	Allow public security bureaus (PSBs) to initiate investigations based on prima facie evidence of probable cause so that assets may be frozen before raids are conducted..
N.A.	<i>Suggested addition:.</i>
	Revise the Opinion on Promptly Transferring Suspected Criminal Cases during Administrative Investigation, issued by the Supreme People's Procuratorate, Ministry of Public Security (MPS), Ministry of Supervision, and Leading Group on National Rectification and Standardization of Market Order, and the Interim Rules on Strengthening Cooperation between PSBs and Customs in IPR Enforcement, issued by the General Administration of Customs (GAC) and MPS, to clarify PSB obligations to file cases and initiate investigations based upon reasonable suspicion of crime..
PRC IMPLEMENTING REGULATIONS TO THE TRADEMARK LAW	

PRC CRIMINAL PROCEDURE LAW—Continued

EXISTING	SUGGESTED MODIFICATION
EXISTING	SUGGESTED MODIFICATION.
Chapter VII, Article 52 sets the maximum fine for violations of trademarks at three times the illegal revenues or, when revenues cannot be calculated, at less than RMB 100,000.	A minimum fine that is sufficient to deter future infringements should be specified to remove the infringer's monetary incentive..
	Include punitive damages sufficient to deter future infringements..
N.A.	<i>Suggested additions:</i> .
	Require violators to pay for storage and destruction costs for counterfeit goods..
	Mandate that counterfeit merchandise be destroyed..
IMPLEMENTING MEASURES ON THE PRC CUSTOMS IPR PROTECTION RULES	
EXISTING	SUGGESTED MODIFICATION.
Chapter 3, Article 15 requires brand owners to post a bond to request Customs to seize possible infringing goods. Once Customs seizes the goods, Chapter 4, Article 27 requires brand owners to get an order from a people's court to sustain the validity of the seizure, which requires a second bond with the people's court.	Mandate the transfer of bonds from Customs to people's courts so that two bonds are not required..
Chapter 4, Article 26 gives Customs 30 working days to report to IP owners with the findings of their investigations.	Provide IP owners with immediate access to information on counterfeiting cases gathered by Customs..
Chapter 4, Article 27 stipulates the conditions for transferring cases from Customs to people's courts.	Include presumptions of knowledge in the transfer rules that include individuals who would have reasonable grounds to know IPR violations are occurring..
	Stipulate that if counterfeit labels are not on the products but being shipped with products, the products can be seized as well..
	Make trading companies liable for counterfeit products shipped using their permits or under their names..
	Require import/export companies to make public information on destination and purchaser/receiver of counterfeit shipments..
	Create a system to monitor counterfeiters involved in previous Customs seizures and list their names publicly. Require future shipments from the same counterfeiters to undergo Customs auditing for a specified period of time..

PRC CRIMINAL PROCEDURE LAW—Continued

EXISTING	SUGGESTED MODIFICATION
Chapter 4, Article 29 allows travelers to carry a “reasonable amount of counterfeit or pirated goods for personal use.”	This provision should be deleted—no counterfeit or pirated goods should be allowed to be used or carried under the law..
N.A.	<i>Suggested additions:</i> .
	Apply presumption of knowledge and criminal procedures to factory suppliers and trading companies that export counterfeit and pirated goods..
	Give Customs power to impose fines that are sufficient to deter future infringements on exporters of counterfeit and pirated products..

